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EXPORT TRADING COMPANY AMENDMENTS ACT OF 1985

COMPLETED

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HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE
AND MONETARY POLICY

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

ON

ORIGINAL

S. 1934

TO AMEND THE BANK EXPORT SERVICES ACT

JUNE 17, 1986

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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I

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EXPORT TRADING COMPANY AMENDMENTS ACT OF 1985

TUESDAY, JUNE 17, 1986

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY,

Washington, DC.

The subcommittee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator John Heinz (chairman of the subcommittee) presiding.

Present: Senators Heinz, Mattingly, Hecht, Proxmire, and Dixon.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Ladies and gentlemen, the subcommittee will come to order.

Today we are going to hear testimony on S. 1934, the bill I introduced to facilitate the further expansion of bank export trading companies, and in the interest of time, because Mr. Johnson of the Federal Reserve has a 10:30 Federal Reserve Board meeting, I'm going to insert my statement in the record and I would urge members to do the same.

I would just make one observation and that is that most of the operating export trading companies [ETC's] to date are relatively small ventures with marginal profitability and in reviewing their operations it is clear to me that their viability has been restricted by overcautious and inappropriate implementation of the 1982 act.

Passage of the act was intended to open the door for banks to engage in trade-related activities and in order to take advantage of the increasing link between trade and finance in world trade.

Unfortunately, the Federal Reserve Board in particular has focused more on limiting export trading companies than promoting them. The Board has interpreted the act very restrictively in the areas of the definition of an export trading company, trade in services, collateral requirements, leverage limits, and inventory ceilings. The Fed, in effect, has launched these new enterprises and given them four or five large anchors to drag at the same time.

My statement goes on in some additional detail as to those problems and it will be included in the record.

[The complete prepared statement and Senate bill S. 1934 follow:]

STATEMENT OF SENATOR HEINZ

Today, the subcommittee will hear testimony on S. 1934, the bill I introduced to facilitate further expansion of bank export trading companies. This bill amends title II of the 1982 Export Trading Company Act which encouraged formation of export trading company ETC's by removing the prohibition against bank investment in and control of ETC's and providing a certificate of review preclearance process for compliance with our antitrust laws.

Unfortunately, this exciting idea has produced only modest results thus far. So far 57 companies have received antitrust waivers from the Commerce Department and 40 bank ETC's, with a total investment of $84 million, have been formed. This level of ETC activity is not necessarily disappointing when we consider that the act has effectively been in force only 3 years and that the normal startup problems of these new ventures were aggravated by rapid appreciation of the dollar and the LDC debt problem which devastated our exports and produced record trade deficits.

What does worry me is the fact that most of operating ETC's are relatively small ventures with marginal profitability. In reviewing their operations it is clear their viability has been restricted by overcautious and inappropriate implementation of the 1982 act. Passage of the ETC act was intended to "open the door" for banks to engage in trade-related activities in order to take advantage of the increasing link between trade and finance in world trade. Unfortunately, the Federal Reserve Board has focused more on limiting ETC's than promoting them.

The Board has interpreted the act very restrictively in the areas of definition of an ETC, trade in services, collateral requirements, leverage limits, and inventory ceilings. The Fed in effect has launched these new enterprises, and given them four or five large anchors to drag at the same time.

Our trade problems are too great and our deficit too large for this situation to continue. My view, which is shared by the General Accounting Office, is that changes must be made in the Fed's guidelines if we are to encourage growth of sound and successful ETC's. S. 1934 corrects these deficiencies in a straightforward manner.

It excludes third country transactions from the net export revenue test that defines an ETC under the act.

It permits an ETC to export services by related or unrelated parties whether or not the services are tied to the export of goods.

It prohibits the Fed from denying an application solely on the basis of an assets-to-equity ratio unless it exceeds 25 to 1, the typical ratio for foreign ETC's.

It precludes application of an across-the-board flat dollar limit, currently $2 million, on inventory levels.

It exempts ETC's from the collateral requirements of section 23A of the Federal Reserve Act, which have been applied too restrictively by the Fed, and which duplicate the protection provided by limits on bank holding company investment in and lending to affiliated ETC's that are in the ETC Act.

Most of these amendments, aside from the first and the last, address the overcautious regulatory policies of the Fed rather than flaws in the original legislation. It would be quicker for the Board to change its attitude than it might be to pass this bill, but there is as yet little sign that might happen, and thus I intend to move forward with the legislation.

I look forward to today's testimony on these issues and to passage of S. 1934 so that we will permit vigorous U.S. trading companies to lead our trade recovery, aided by a competitive dollar and an improving export environment.

II

99TH CONGRESS
1ST SESSION

S. 1934

To amend the Bank Export Services Act.

IN THE SENATE OF THE UNITED STATES

DECEMBER 12 (legislative day, DECEMBER 9), 1985

Mr. HEINZ introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To amend the Bank Export Services Act.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

SECTION 1. This Act may be cited as the "Export Trading Company Amendments Act of 1985".

DEFINITION OF EXPORT TRADING COMPANY

SEC. 2. Section 14(c)(14)(F)(i) of the Bank Holding Company Act of 1956 is amended to read as follows:

"(i) the term 'export trading company' means a company which does business under the laws of the United States or any State, which is exclusively engaged in activities related to international trade, and which is organized and operated principally for purposes of exporting goods or services produced in the United States by the company, its affiliates, or unaffiliated persons, or for purposes of providing one or more export trade services to facilitate the exportation of goods or services produced in the United States by unaffiliated persons. A company shall be deemed to be organized and operated principally for such purposes if its revenues from exporting goods or services produced in the United States or from providing export trade services, as defined in clause (ii), exceed its revenues from importing into the United States goods or services produced outside the United States.".

RELATIONS WITH AFFILIATES

Sec. 3. Section 23A(d) of the Federal Reserve Act (12 U.S.C. 371c(d)) is amended—

(1) by striking out "and" at the end of paragraph (6);

(2) by striking out the period at the end of paragraph (7) and inserting in lieu thereof "; and"; and

(3) by adding at the end thereof the following:

"(8) transactions with an affiliate which is an export trading company as defined in section 4(c)(14)(F)(i) of the Bank Holding Company Act of 1956.".

LEVERAGE

SEC. 4. Section 4(c)(14)(A)(iv) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)(14)(A)(iv)) is amended by adding at the end thereof the following:

> "The Board may not disapprove a proposed investment solely on the basis of the proposed assets to equity ratio of an export trading company unless the proposed annual average ratio is greater than twenty-five to one.".

INVENTORY

SEC. 5. (a) Section 4(c)(14)(A) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)(14)(A)) is amended—

(1) by redesignating subparagraphs (v) and (vi) as subparagraphs (vi) and (vii), respectively; and

(2) by inserting after subparagraph (iv) the following:

> "(v) The Board may not impose, by regulation, a dollar limit on the amount of goods which export trading companies may maintain in inventory. However, the Board may impose, by order, a dollar limit on the amount of goods which a particular export trading company may maintain in inventory if, under the particular facts and circumstances, it finds that such limit is necessary to prevent risks that would affect the financial or

managerial resources of an investor bank holding company to an extent which is likely to have a materially adverse effect on the safety and soundness of any subsidiary bank of such bank holding company.".

○

Senator **Heinz**. I also ask unanimous consent from Senator Dixon to include his statement in the record at the appropriate point.

[The complete prepared statement follows:]

Statement of Senator Alan Dixon

Senator **Dixon**. Mr. Chairman, I am pleased to be here this morning as the committee considers S. 1934, the Export Trading Company Amendments Act of 1986.

Export trading companies can help improve our long-term international competitiveness, and can provide new markets for small- and medium-sized American businesses that are unable to get into the export business on their own.

I am aware that the growth of export trading companies, particularly bank-operated export trading companies, has not been as rapid as had been predicted when the legislation was passed. This hearing provides an opportunity to look into the impediments to export trading company growth that seem to be caused in no small part by the manner in which the act has been implemented.

S. 1934 is designed to improve the climate for bank-operated export trading companies. I look forward to hearing from today's group of distinguished and expert witnesses on the bill, and on other issues facing export trading companies. I believe we must do all we can to improve our ability to compete with the Japanese and other major trading countries. Acting on S. 1934 would be a small but significant step toward that objective.

Senator **Heinz**. I'm pleased to yield to my friend and colleague from Wisconsin, Senator Proxmire, the ranking minority member of the subcommittee.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator **Proxmire**. Thank you, Mr. Chairman.

Mr. Chairman, I will read my statement because I think it sets forth the nature of the disagreement that you and I have on this matter of export trading companies and I want to state it on the record.

In 1982 the Congress passed the Export Trading Company Act which was designed to encourage exports by facilitating the formation and operation of export trading companies, export trade associations and the expansion of export trade services generally.

That act had three principal titles. Titles III and IV made amendments to America's antitrust laws and set up a certification process, administered by the Commerce Department, under which exporters can obtain assurances that their cooperative activities in fixing export prices and market shares will not be prosecuted. At the time this committee last considered ETC legislation I said that provision only endorsed the principle of export cartels—such as we all condemn when it is OPEC that is doing the price fixing.

I'm pleased to note that at least the proposed bill that is before us today does not attempt to widen the present antitrust exemption contained in the Export Trading Company Act. That's probably the only good thing I can say about it.

The 1982 act also contained a title II known as the Bank Export Services Act. It provides a limited exception to the nonbanking prohibitions in the Bank Holding Company Act by permitting bank holding companies and certain other types of banking organizations to make equity investments in export trading companies.

The title represented a dramatic departure from traditional banking legislation in that it permitted participation by banking organizations in commercial ventures. Both the Federal Reserve and the FDIC said this breach of the separation of banking and commerce posed substantial risks to the safety and soundness of our banking system. They recommended that our banks not be permitted to control export trading companies. I supported the Fed and the FDIC in their opposition to the then proposed bill.

The Congress, however, was appalled by the size of our then $36 billion trade deficit—$36 billion. It was willing to conclude that bank affiliated export trading companies might give us leverage to compete with the massive Japanese export companies. It lost sight of the fact that the Japanese, because of their own concerns about the safety of their financial system, limit banks to only a 5-percent ownership share in trading companies.

The Congress in 1982 allowed U.S. banks into export commerce but included a number of safeguards in title II to limit the potential adverse consequences of that decision. It charged the Federal Reserve with administering these safeguards.

Now less than 4 years after the passage of that so-called historic legislation, the United States finds itself with a trade deficit of over $120 billion. At least part of this trade deficit is due to the foolish decisions our banks made with regard to foreign loans. Interest on those billions of dollars of loans allow the debtor nations little money to buy American goods.

Rather than deal with that real banking problem, we find the banks once again seeking to expand the loophole into commerce given them by the 1982 act. They blame the Fed for failing to administer the act properly and claim that that is the reason the banks have not made use of the provisions of that bill.

Frankly, Mr. Chairman, I'm very skeptical of such assertions. I note that smaller nonbank affiliated export trading companies claim that enactment of S. 1934, your bill, will give bank affiliated export companies a huge competitive advantage. Passage of the bill, they allege, would drive independent export trading companies out of the marketplace. There are over 2,000 such independent ETC's and they account for a lot of exports. We should not weaken them by passing this legislation.

Mr. Chairman, I look forward to hearing our witnesses and in particular Mr. Johnson of the Fed. I understand he will give a point-by-point refutation of the proposed revisions of S. 1934. I, for the life of me, cannot understand why people believe adopting provisions that could weaken our banking system will help our trading position.

Thank you, Mr. Chairman.

Senator HEINZ. Senator Proxmire, thank you very much.

Let me ask our first three witnesses to come forward: Dr. Manuel Johnson, Governor of the Federal Reserve Board; David Luft, Deputy Assistant Secretary of Commerce for Services; and Allan Mendelowitz, of the General Accounting Office.

Senator PROXMIRE. Mr. Chairman, I'm going to have to leave temporarily, but I will come back as soon as I can.

Senator HEINZ. Very well.

Dr. Johnson, would you please proceed with your testimony.

STATEMENT OF MANUEL H. JOHNSON, JR., GOVERNOR, FEDERAL RESERVE SYSTEM

Dr. JOHNSON. Thank you, Mr. Chairman. Thank you for the opportunity to present the views of the Federal Reserve Board on S. 1934, the bill to amend the Export Trading Company Act of 1982.

Before I do that, I have a longer statement to submit for the record, but I do have a summary of my remarks.

We at the Board support efforts to lower this country's trade deficit and wish to work with Congress in attempting to arrive at solutions to the problem.

The Export Trading Company Act of 1982, the ETC Act, was designed to help promote exports by facilitating the formation and operation of ETC's. The BESA, the Bank Export Services Act, provides a limited exception to the nonbanking prohibitions of the Bank Holding Company Act by permitting bank holding companies and certain other types of banking organizations to make equity investments in ETC's. Thus, the BESA represents a dramatic departure from traditional banking legislation in permitting participation by banking organizations in commercial ventures.

In recognition of this expanded latitude, Congress included a number of prudential safeguards such as investment and lending limitations to circumscribe potential adverse financial effects on banks affiliated with ETC's.

As you are well aware, the economic climate since the ETC Act was passed has not been favorable to exports. The act was signed during the fourth quarter of 1982 when the U.S. economy was in the depths of a recession and the volume of exports had fallen more than 20 percent from its peak in 1980. Since that time U.S. output and employment have expanded rapidly.

U.S. EXPORTS STILL REMAIN BELOW 1980 PEAK

By contrast though, U.S. exports have rebounded only moderately and still remain below their 1980 peak. The U.S. trade deficit increased from $25 billion in 1980 to approximately $125 billion in 1985.

The weakness of U.S. exports can be attributed to a number of macroeconomic developments that took place in the early to mid-1980's and have continued until fairly recently. These factors include the rise of the dollar against foreign currencies, the relatively sluggish growth of foreign economies, and the drop in imports by countries experiencing problems meeting their external debt obligations.

Moreover, at the time the act was passed, the trading company generally was not a prominent vehicle for selling U.S. exports. It was unlikely that the pattern of U.S. businesses with exporting capabilities could be changed in only a few years.

Notwithstanding this business environment, 40 bank holding companies have notified the Federal Reserve System of their intent to invest in ETC's. Several of these ETC's appear to be operating profitably and expanding their overseas operations.

In contrast, the performance of many other bank affiliated ETC's has been disappointing, I admit. In fact, 11 are no longer operational. In addition to poor economic conditions in their first years of existence resulting in diminished profit potential, these ETC's have also encountered startup difficulties resulting from unfamiliarity with the trading business and other problems peculiar to the activities of trading companies.

There is no evidence, however, that ETC's affiliated with banks have been any less successful than trading companies that have no connection with banking organizations. Many of these trading companies reported to the GAO that business has been disappointing citing economic factors, particularly the high value of the dollar, as the reason.

Although the purpose of S. 1934 is to promote the formation and performance of bank affiliated ETC's, some of its provisions present serious issues related to the safety and soundness of banking organizations investing in ETC's.

TWO PROVISIONS RAISE SUPERVISORY CONCERNS

Let me address these provisions before discussing two that raise fewer supervisory concerns.

Section 23A of the Federal Reserve Act is a cornerstone of the regulatory structure for protecting banks from credit judgments made for noncommercial reasons. It generally limits the amount of credit that banks may extend to a nonbank affiliate and subjects such credit extensions to certain collateral requirements.

S. 1934 would exempt from section 23A a bank's transactions with its affiliated ETC. Experience over the years has demonstrated that limitations on self-dealing between a bank and its affiliates are essential to help curb abuses, to maintain bank safety and soundness, and to prevent excessive risk to the Federal safety net.

Congress also has recognized the importance of the protections found in section 23A. Every deregulatory proposal in the last 4 years has, in fact, used section 23A as the central mechanism for preserving the safety and soundness of banking organizations with expanded powers to enter the nonbanking areas.

I should note that the Board has included in its regulations a waiver from the strict collateralization standards of section 23A for those transactions in which the ETC takes title to goods against a firm order and the lending bank actually maintains a security interest in those goods. A waiver under those circumstances would not create undue risk to an affiliated bank.

Another provision of S. 1934 would prohibit the Board from disapproving a bank's investment in an ETC solely on the basis of a proposed asset-to-equity ratio unless that ratio were greater than 25 to 1. The Board, by reason of its responsibility as a bank regulator, has historically recognized the need for the maintenance of adequate capital in individual State member banks and bank holding companies and in the banking system in general.

Congress, too, has recognized the necessity for banking organizations to maintain adequate capital. In the International Lending Supervision Act of 1983, Congress required the bank regulatory agencies to "cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of capital for such banking institutions."

In the case of ETC's, the Board strongly recommends against the proposed legislative standard for the leveraging of ETC's. The Board must be able to examine carefully the capital structure of bank affiliated ETC's. Capital adequacy is a critical determinant of the financial strength of the ETC and of its ability to withstand unexpected adverse developments so as not to affect the financial resources of the parent holding company or the safety and soundness of affiliated banks.

Many factors must be taken into account, such as the nature of the ETC's business, the size of its inventory, and the size of the bank holding company's investment in the ETC. Only a case-by-case analysis permits all these factors to be taken adequately into account. The Board has, in fact, taken a flexible approach and has approved in one case a leveraging ratio of as much as 17 to 1.

THIRD PROVISION MODIFIES DEFINITION OF AN ETC

A third provision of S. 1934 would modify the definition of an ETC to include companies that principally export goods or services produced by themselves or any of their affiliates. This revision would permit the bank to invest in any company that provides its own services to foreign customers regardless of whether the services relate to trade.

The common thread throughout consideration of the original legislation was that the experience and expertise of banks in financing foreign investment was thought to be needed by export trading companies—companies that serve as intermediaries for producers and suppliers of goods and services in foreign markets by providing a range of export trade services. It was not intended that banking organizations would serve as a source of capital investment in various service industries generally and assume the risk associated with those industries.

The Board's regulations do not limit the ability of bank affiliated ETC's to, in fact, offer a broad range of trade-related services, both in the United States and abroad. For example, the BESA and the regulations permit ETC's to provide consulting, market research, marketing, insurance product research and design, legal assistance, and many other services. Moreover, the Board has recognized that this list of services is really not exhaustive by approving other trade-related activities.

The practical effect of S. 1934 would be to change the congressionally intended emphasis in the BESA. It would provide a vehicle by which commercial banking organizations through the medium of an ETC would acquire organizations serving overseas customers without any benefit to the U.S. trade or balance of payments position. The proposal would thus have the effect of changing the incentive in the ETC Act to promote U.S. exports while potentially undermining the public policy objectives embodied in the separation of banking and commerce.

Such important public policy issues we think should be addressed directly and not indirectly through technical changes in the BESA.

The last two provisions of S. 1934 which I will now discuss appear to raise fewer supervisory concerns on our part.

First, the BESA defines an ETC as a company "organized and operated principally for purposes of exporting goods and services produced in the United States."

Under S. 1934, a company would qualify as an export trading company if its revenues from exports exceed its revenues from imports. Revenues derived from third-party trade or associated with countertrade would be excluded from the calculation. This would mean that an export trading company could be a company with minimal involvement in exporting goods or services from the United States. Such a result would amount to a substantial alteration of congressional intent as to the purposes of ETC's to promote the export of U.S. goods and services.

Ultimately, however, it is up to Congress to determine whether ETC's should continue to have as their primary purpose the export of U.S. goods and services.

Second, the Board's regulations provide that a notice to invest in an ETC may be delegated to the appropriate Federal Reserve Bank rather than reviewed by the Board if the proposed export trading company will take title to goods only against firm orders or if its inventory is worth less than $2 million.

The Board has, in fact, reviewed and did not object to several notices where projected inventory was proposed to be substantially greater than $2 million. S. 1934 prohibits the Board from imposing a dollar limit on an ETC's inventory unless the Board finds that a limit is necessary to prevent material adverse effects of a bank affiliate of an ETC.

We believe this provision would provide the Board with sufficient discretion to deal with supervisory concerns and have no real problem with this.

In conclusion, I would like to emphasize again the Board's support for a strengthened and expanded export sector of the U.S. economy. In this context, we would urge Congress to allow for a fair testing of the existing law and to refrain at this time from adopting some of the proposed amendments.

Thank you.

[The complete prepared statement follows:]

Statement by

Manuel H. Johnson, Jr.

Member, Board of Governors of the Federal Reserve System

Thank you for the opportunity to present the views of the Federal Reserve Board on S. 1934, the bill to amend the Export Trading Company Act of 1982. We at the Board support efforts to lower this country's trade deficit, and wish to work with Congress in attempting to arrive at solutions to the problem. It is not the view of the Board, however, that amending the Bank Export Services Act ("BESA") is necessary at this time. Given the unfavorable economic conditions that have existed since enactment of the BESA, we feel the existing statute has not been given a fair test, and that its effectiveness should be evaluated in the future. As to the specific provisions of S.1934, the Board opposes three of the revisions to the BESA proposed in the bill on grounds of safety and soundness, but has fewer reservations concerning two other proposed revisions.

In my testimony, I will review briefly the Board's implementation to date of the BESA (Title II of the Export Trading Company Act of 1982), discuss some of the experiences of bank-affiliated export trading companies ("ETCs") and other trading companies, and analyze and give in greater detail the Board's views on the provisions of S. 1934.

The BESA and the Board's Regulations

The Export Trading Company Act of 1982 ("ETC Act") was designed to help promote exports by facilitating the formation and operation of ETCs. The BESA provides a limited exception to the nonbanking prohibitions of the Bank Holding Company Act by permitting bank holding companies and certain other types of banking organizations to make equity investments in ETCs. The purposes of the BESA were: (1) to provide for the establishment of U. S. ETCs that could be competitive with foreign-owned ETCs; (2) to provide U. S. commerce, industry and agriculture, especially small and medium-sized firms with a means of exporting their goods and services; (3) to foster the participation by regional and smaller banks in the development of ETCs; and (4) to facilitate the formation of joint venture ETCs between bank holding companies and nonbank firms.

Thus, the BESA represents a dramatic departure from traditional banking legislation in that it permits participation by banking organizations in commercial ventures. In recognition of this expanded latitude, however, Congress included a number of prudential safeguards to limit potential adverse financial effects on banks affiliated with ETCs. The statute provides that a bank holding company may not invest more than 5 percent of its consolidated capital and surplus in an ETC nor lend more than 10 percent of its consolidated capital and surplus to an ETC. It also provides that a bank holding company may invest in an ETC only after allowing for review by the Federal Reserve. The Federal Reserve is required to review the notice in order to determine whether the proposal may result in unsafe or unsound banking practices, undue concentration of resources, decreased or unfair competition, or conflicts of interest, or whether the investment would have a materially adverse effect on the safety and soundness of a subsidiary bank of the bank holding company.

The Board issued final regulations implementing the BESA in June, 1983. These regulations were later modified to simplify the notification process and provide for delegated authority to the individual Federal Reserve Banks to review certain ETC notifications. Virtually all of the notifications of intent to establish ETCs have been acted upon within the 60-day time period set forth in the statute, and no notification by a bank to invest in an ETC has been disapproved. Fifteen of the 24 ETC notifications filed after the adoption of the delegation procedures were processed by the Reserve Banks with no Board review.

Response to the Act

As you are well aware, the economic climate since the ETC Act was passed has not been favorable to exports. The Act was signed during the fourth quarter of 1982 when the U.S. economy was in the depths of a recession and the volume of exports had fallen more than 20 percent from its peak in 1980. Since that time, U.S. output and employment have expanded rapidly. By contrast, U.S. exports have rebounded only moderately and still remain below their 1980 peak. The U.S. trade deficit increased from $25 billion in 1980 to approximately $125 billion in 1985.

The weakness of U.S. exports can be attributed to a number of macroeconomic developments that took place in the early to mid-1980's and that have continued until fairly recently. These factors include the rise of the dollar against foreign currencies; the relatively sluggish growth of foreign economies; and the drop in imports by countries experiencing problems meeting their external debt obligations.

Moreover, as was discussed during early hearings on the BESA, U.S. manufacturers have not traditionally made widespread use of trading companies as a medium for exporting their goods. By one estimate, in 1982, there were about 2,000 American-owned trading companies active in the United States. However, these companies were involved in only about ten percent of all U.S. exports. Larger U.S. multi-national companies with substantial sales abroad had their own in-house marketing capability or a few had trading company subsidiaries. Thus, at the time the Act was passed, the trading company generally was not a prominent vehicle for selling U.S. exports, and it was unlikely that the patterns of U.S. businesses with exporting capabilities could be changed in only a few years.

Notwithstanding this business environment, 40 bank holding companies have notified the Federal Reserve System of their intent to invest in ETCs. (Tables attached as an Appendix to this testimony show the status of each ETC notification acted upon by the System). Several of these ETCs appear to be operating profitably and expanding their overseas operations.

In contrast, the performance of many of these bank-affiliated ETCs has been disappointing. In fact, eleven are no longer operational. In addition to poor economic conditions in their first years of existence resulting in diminished profit potential, these ETCs have also encountered start-up difficulties resulting from unfamiliarity with the trading business. Other problems encountered are peculiar to the activities of trading companies, regardless of how long they have been operating. For example, one ETC experienced substantial difficulties because a major customer broke the terms of its trade agreement; another lost its capital because of its inability to deliver on a major contract; and a third was closed after suffering significant losses resulting from the lack of adequate controls over its trading activities. At least four bank holding companies have discontinued the operations of their ETCs either temporarily or permanently because the operating losses were found to be unacceptable.

There is no evidence, however, that ETCs affiliated with banks have been any less successful than trading companies that have no connection with banking organizations. While there is no means of tracking all these trading companies, the General Accounting Office has conducted a survey of 23 trading organizations that have obtained certificates of review from the Department of Commerce. Many of these firms reported that business has been disappointing, citing economic factors, particularly the high value of the dollar as the reason. It is also interesting to note that the membership of the National Association of Export Companies, an organization composed primarily of nonbank export trading companies, dropped by half in the last four years, and is only beginning to increase again. This drop in membership is reportedly a result of the fact that many of the member companies have gone out of business.

S. 1934

There is an understandable concern about the mediocre performance of ETCs since the passage of the Act resulting in attempts to deal with the situation by amending sections of the BESA. The amendments would modify certain of the Board's regulations. Broad trends, however, such as unfavorable economic conditions -- not the Board's regulations -- have impeded the results of the legislation. Moreover, three of the bill's provisions present serious issues related to the safety and soundness of banking organizations investing in ETCs. From a supervisory standpoint, we are less concerned about the other two provisions. However, I would note that the provision dealing with the calculation of export revenues does raise policy questions about Congressional intent in establishing ETCs to foster U.S. exports.

1. Transactions with Affiliates

The BESA provides that extensions of credit from a bank to its affiliated ETC are covered by section 23A of the Federal Reserve Act. Section 23A is a cornerstone of the regulatory structure for protecting banks from credit judgments made for noncommercial reasons. It generally limits the amount of credit that banks may extend to a nonbank affiliate and subjects such credit extensions to certain collateral requirements.

S. 1934 would exempt from section 23A of the Federal Reserve Act a bank's transactions with its affiliated ETC. The purpose of this exemption, according to the statement introducing the bill, is to remove a competitive "disadvantage" from ETCs, permitting them to borrow from their affiliated bank without meeting the collateral requirements of section 23A.

Experience over the years has demonstrated that limitations on self-dealing between a bank and its affiliates are essential to help curb abuses, to maintain bank safety and soundness and to prevent excessive risk to the federal safety net. Congress also has recognized the importance of the protections found in 23A -- every deregulatory proposal in the last four years has used section 23A as the central mechanism for preserving the safety and soundness of banking organizations with expanded powers to enter nonbanking areas.

The experience to date reinforces the desirability of maintaining the protections afforded by section 23A. In one case, a bank lent to its affiliated ETC amounts in violation of section 23A without required collateral. The ETC was unable to repay the advances and thus the condition of the bank was affected. Had section 23A been complied with, the bank would not have exposed itself to these losses. Therefore, an exemption from section 23A for transactions with an ETC does not appear to be in the best interests of preserving safety and soundness as it creates the opportunity for a bank's resources to be misused in support of the affiliate's trading activities. In the area of extensions of credit, it is most important to strike the proper balance between encouraging the growth of ETCs and preventing imprudent banking practices. Moreover, the application of section 23A does not impose a competitive disadvantage on ETCs affiliated with banks. They, like other trading companies, are free to borrow from unaffiliated lenders on terms determined by the market.

The Board as a matter of policy has generally not granted exemptions from section 23A. With respect to ETCs, however, the Board has included in its regulations a waiver from the strict collateralization standards of section 23A for those transactions in which the ETC takes title to goods against a firm order and the lending bank maintains a security interest in those goods. The Board has determined that in these circumstances a waiver would permit ETCs to obtain financing for transactions in goods without creating undue risk to the affiliated bank. In addition, the Board has stated that it would consider granting ETCs additional waivers from these collateral requirements based on specific requests.

The bill also would relieve extensions of credit by a bank to its affiliated ETC from the quantitative limits of section 23A. These limitations provide that a bank may lend no more than ten percent of its capital and surplus to an affiliate. The BESA itself limits extensions of credit by a bank holding company or its subsidiaries to an affiliated ETC to ten percent of the holding company's capital and surplus. Thus, the bill's proposed exemption could have the effect of significantly increasing the exposure of a bank to its affiliates. The Board strongly recommends that the quantitative limits on these extensions of credit be retained.

2. Capital Adequacy

In reviewing notices by banking organizations to invest in ETCs, the Board considers the assets to equity ratio of each proposed ETC on a case-by-case basis, taking into account, among other factors, the riskiness of the ETC's proposed activities. S. 1934 would prohibit the Board from disapproving a bank's investment in an ETC solely on the basis of the proposed asset to equity ratio unless that ratio were greater than 25 to 1.

The Board, by reason of its responsibilities as a bank regulator, has historically recognized the need for the maintenance of adequate capital in individual state member banks and bank holding companies and in the banking system in general. Capital provides a buffer for banking organizations in times of poor performance, helps to maintain public confidence in particular banking organizations and in the banking system, and supports the reasonable growth of banking organizations. An evaluation of capital adequacy is one of the major purposes of a bank or bank holding company examination.

Congress has recognized the necessity for banking organizations to maintain adequate capital. In the International Lending Supervision Act of 1983, Congress required the bank regulatory agencies to "cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of capital for such banking institutions." For this purpose, capital requirements are assessed on a consolidated basis, although the capital adequacy of subsidiary organizations is also taken into account. The latter is necessary because the condition of affiliated organizations can have an important effect on their related banks.

In the case of ETCs the Board strongly recommends against the proposed legislative standard for the leveraging of ETCs. In carrying out its duty to preserve the safe and sound operation of bank holding companies, the Board must be able to examine carefully the capital structure and proposed leveraging ratios of bank-affiliated ETCs. Capital adequacy is a critical determinant of the financial strength of the ETC and of its ability to withstand unexpected adverse developments so as not to affect the financial resources of the parent holding company or the safety and soundness of affiliated banks. There is no justification for a statutory rule allowing a minimum capital level for bank-affiliated ETCs substantially less than that required for banks, when the ETCs' activities are likely to be outside the normal range of banking operations and therefore present greater, not fewer, risks. Thus, we do not adhere to the presumption of S. 1934 that a leveraging ratio of 25:1 would be consistent with the sound financial operation of an ETC. Many factors must be taken into account, such as the nature of the ETC's business, the size of its inventory, and the size of the bank holding company's investment in the ETC. Only a case-by-case analysis permits all these factors to be taken adequately into account.

In this regard, the Board recently acted on a request from a bank holding company to adopt a leveraging ratio for its ETC that was higher than the 10:1 ratio it had proposed in an earlier notification to a Federal Reserve Bank. After determining that the nature and riskiness of the activities proposed for the ETC were similar to those of secured lending transactions, the Board approved a leveraging ratio of 17:1. This action is illustrative of the flexible approach followed by the Board with respect to the capitalization of ETCs.

In light of the critical importance of the capital adequacy of each subsidiary company in a bank holding company organization, the Board needs to retain its discretion in this area.

3. Exporting Services

The BESA, read together with the Board's regulations, defines an ETC in which a banking organization is permitted to invest as a company that is exclusively engaged in international trade, and that principally exports, or provides services to facilitate the export of, goods and services produced by others. S. 1934 would modify the definition of an ETC to include companies that principally export goods or services produced by themselves or any of their affiliates. This revision would permit a bank to invest in any company that provides its own services to foreign customers regardless of whether the services relate to trade.

The common thread throughout consideration of the original legislation was that the experience and expertise of banks in financing foreign investment was thought to be needed by export trading companies -- companies that serve as intermediaries for producers and suppliers of goods and services in the foreign marketing and sale of their products by providing a range of export trade services. It was not intended that banking organizations would serve as a source of capital investment in various service industries generally and assume the risks associated with those industries.

The Board's regulations do not limit the ability of bank-affiliated ETCs to offer a broad range of trade-related services both in the United States and abroad. For example, the BESA and the regulations permit ETCs to provide consulting, market research, marketing, insurance product research and design, legal assistance, transportation including freight forwarding, warehousing, foreign exchange, financing and taking title to goods, when provided in order to facilitate the trade in goods and services produced by others. According to the notifications to the Federal Reserve, a number of ETCs are providing many of the trade services included in this list. Moreover, the Board has recognized that this list of services is not exhaustive. For example, upon demonstrating that the activities were related to international trade, one ETC has acquired a company in England that engages in customs bonding services and in certain types of inventory control services related to cross-border trade. In addition, the Board has responded favorably to several export trading company notifications that specifically contemplated the establishment of overseas offices and divisions.

The practical effect of S. 1934 would be to change the Congressionally intended emphasis in the BESA from promoting U.S. exports and employment to providing a vehicle by which commercial banking organizations, through the medium of an ETC, could acquire organizations serving overseas customers without any benefit to the United States trade or balance of payments position. The proposal would thus have the effect of changing the incentive in the ETC Act to promote U.S. exports, while potentially undermining the public policy objectives embodied in the separation of banking and commerce. Such important public policy issues should be addressed directly and not indirectly through technical changes in the BESA.

While the last two provisions of S. 1934, which I will now discuss, appear to raise few supervisory concerns on our part, the calculation of the export revenues provision, as I have mentioned, does raise questions of policy.

1. Calculation of Export Revenues

The BESA defines an ETC as a company "organized and operated principally for purposes of exporting [or facilitating the export of] goods and services produced in the United States . . . ." This definition reflects Congress' goal of improving U.S. export performance. In accordance with this purpose, the Board's current regulations require that more than half of an export trading company's revenues over a two-year period be derived from U.S. exports.

Under S. 1934 a company would qualify as an export trading company if its revenues from exports exceed its revenues from imports. Revenues derived from third party trade or associated with countertrade would be excluded from the calculations. This would mean that an "export trading company" could be a company substantially engaged in third party trade or countertrade involving two foreign countries, with minimal involvement in exporting goods or services from the United States. In fact, the proposal could hurt U.S. exports, since the goods being traded outside the United States can be substituted for goods exported from the United States. Such a result would amount to a substantial alteration of Congressional intent as to the purposes of ETCs to promote the export of U.S. goods and services and would be contrary to the original premise for allowing bank holding companies to engage in this activity: that the increased risks undertaken by a bank holding company through an ETC would be counter-balanced by an increase in U.S. exports. Ultimately, however, it is up to Congress to determine whether ETCs should continue to have as their primary purpose the export of U.S. goods and services.

2. Inventory

The Board's regulations provide that a notice to invest in an ETC may be delegated to the appropriate Federal Reserve Bank, rather than reviewed by the Board, if the proposed export trading company will take title to goods only against firm orders, or if its inventory is worth less than $2 million. Taking title to goods involves sufficient risk that the Board felt it should have the opportunity on a case-by-case basis to review carefully proposals involving this activity. The Board wanted to reserve the right to disapprove those proposals that could involve unsafe and unsound practices, as, for example, where a bank-affiliated ETC has an inadequate system of management controls, or where the ETC has insufficient safeguards to protect against a violation of the statutory prohibition against speculation in commodities. The Board has in fact reviewed and did not object to several notices where projected inventory is substantially greater than $2 million.

S. 1934 prohibits the Board from imposing a dollar limit on an ETC's inventory unless the Board finds that the limit is necessary to prevent material adverse effects on a bank affiliate of the ETC. This provision would merely codify the Board's current practice and would provide the Board with sufficient authority to exercise its supervisory powers in this area when necessary.

Conclusion

In conclusion, I would like to emphasize again the Board's support for a strengthened and expanding export sector of the U.S. economy. In this context, we would urge Congress to allow for a fair testing of the existing law and to refrain at this time from adopting the proposed amendments.

APPENDIX 1

NOTIFICATIONS TO ESTABLISH EXPORT TRADING COMPANIES

Bank Holding Company	Export Trading Company	Date of System Action	Current Status
Security Pacific Corporation, San Francisco, CA	Security Pacific Export Trading Company Los Angeles, CA	5/09/83	Operating
Citicorp, New York, NY	Citicorp International Trading Company, New York, NY	5/31/83	Operating
Walter E. Heller International Corporation, Chicago, IL	Heller Trading Company Chicago, IL	6/13/83	Closed
First Interstate Bancorp, Los Angeles, CA	First Interstate Trading Company, Los Angeles, CA	6/15/83	Operating
First Kentucky National Corporation, Louisville, KY	First Kentucky National Trading Company, Louisville, KY	7/25/83	Inactive
Union Bancorp, Inc., Los Angeles, CA	StanChart Export Services Company, Inc., Los Angeles, CA	7/25/83	Operating
Crocker National Corporation, San Francisco, CA	Crocker Pacific Trade Corporation, San Francisco, CA	8/30/83	Closed
Ramapo Financial Corp., Wayne, NJ; Ultra Bancorporation, Bridgewater, NJ; and New Jersey National Corporation, Trenton, NJ	Bancorps' International Trading Corporation, Somerset, NJ	9/14/83	Operating
State Street Boston Corporation, Boston, MA	State Street Trade Development Corporation, Inc., Boston, MA	9/19/83	Sold
International Bancshares Corporation, Laredo, TX	IBC Trading Company, Laredo, TX	10/03/83	Not Activated
United Midwest Bancshares, Inc., Cincinnati, OH	United Midwest International Corporation, Cincinnati, OH		Closed

Bank Holding Company	Export Trading Company	Date of System Action	Current Status
U.S. Bancorp, Portland, OR	U.S. World Trade Corporation, Portland, OR	11/17/83	Inactive
First Chicago Corporation, Chicago, IL	First Chicago Trading Company, Chicago, IL	11/21/83	Operating
Rainier Bancorporation, Seattle, WA	Rainier International Trading Company, Seattle, WA	12/07/83	Operating
Shawmut Corp., Boston, MA	Shawmut Export Corporation, Boston, MA	12/12/83	Operating
Hongkong and Shanghai Banking Corporation, Hong Kong	Equator Trading Company Limited, Hartford, CT	12/27/83	Operating
BankAmerica Corporation, San Francisco, CA	BankAmerica World Trade Corporation, San Francisco, CA	02/02/84	Inactive
Bankers Trust New York Corporation, New York, NY	Bankers Trust International Trading Corporation New York, NY	02/02/84	Operating
First National State Bancorporation, Newark, NJ	First International Trading Co., Newark, NJ	02/13/84*	Operating
Chase Manhattan Corp., New York, NY	Chase Trade, Inc., New York, NY	02/21/84*	Operating
Society Corporation, Cleveland, OH	Export Partnership for International Trade, Inc., Cleveland, OH	03/04/84	Operating
Fleet Financial Group, Inc. Providence, RI	Fleeting Trading Company, Providence, RI	03/19/84*	Inactive
First National Bancshares, Inc. Houma, LA	First Export Corporation, Houma, LA	04/06/84*	Operating
Manufacturers Hanover Corporation, New York, NY	C.I.T. International Sales Corporation, New York, NY	04/24/84	Operating
First Union Corporation, Charlotte, NC	First Union Export Trading Company, Charlotte, NC	05/07/84*	Operating

*Acted upon by Reserve Banks pursuant to Delegated Authority.

Bank Holding Company	Export Trading Company	Date of System Action	Current Status
Alaska Mutual Bancorporation, Anchorage, AK	Mutual International Corporation, Anchorage, AK	06/06/84*	Operating
Frontier Bancorp, Vista, CA	Interbank Trading Company, San Diego, CA	07/30/84*	Not Activated
Florida Park Banks, Inc. St. Petersburg, FL	Park Services International, Inc., St. Petersburg, FL	09/19/84	Closed
Capital Bancorp, Miami, FL	Capital Trade Services, Inc., Miami, FL	09/20/84*	Operating
CoreStates Financial Lancaster, PA	CoreStates Export Trading Company, Philadelphia, PA	10/13/84*	Operating
North Valley Bancorp, Redding, CA	Casia-Pacific Company, Redding, CA	10/18/84*	Operating
Maryland National Corporation, Baltimore, MD	MN Trade Corporation, Baltimore, MD	12/18/84*	Operating
Marine Corporation, Milwaukee, WI	Marine Financial Services, Inc., Milwaukee, WI	12/31/84*	Operating
Ramapo Financial Corp., Wayne, NJ; Ultra Bancorporation, Bridgewater, NJ; and New Jersey National Corporation, Trenton, NJ	Florida Interbank Trading Company, Inc., Jacksonville, FL	01/07/85	Operating
First Wisconsin Corp., Milwaukee, WI	InterContinental Trading Co., Inc., Rolling Meadows, IL	02/11/85	Operating
Commerce Union Corporation, Nashville, TN	Commerce Trading Corporation, Nashville, TN	03/22/85	Operating
Valley National Corporation, Phoenix, AZ	Valley Internation Trading Company, Phoenix, AZ	04/16/85*	Operating

*Acted upon by Reserve Banks pursuant to Delegated Authority.

Bank Holding Company	Export Trading Company	Date of System Action	Current Status
Manufacturers Hanover Corporation, New York, NY	Manufacturers Hanover World Trade Corporation, New York, NY	04/21/85*	Operating
Marine Midland Banks, Inc., Buffalo, NY	Marine Midland Trade, Inc., New York, NY	04/21/85*	Operating
United Bancorp of Arizona, Phoenix, AZ	United Bank Export Trading Company, Phoenix, AZ	07/05/85	Operating
InterFirst Corporation, Dallas, Texas	InterFirst World Trade Corporation, Dallas, Texas	04/28/86	Operating

*Acted upon by Reserve Banks pursuant to Delegated Authority.

OTHER EXPORT TRADING COMPANY NOTIFICATIONS

Bank Holding Company	Export Trading Company	Date of System Action[1]	Request
Security Pacific Corporation, Los Angeles, CA	Security Pacific Trading Co.	01/18/84	Expand Activities[2]
Society Corporation, Cleveland, OH	Export Partnership for Intercontinental Trade Inc.	03/20/85	Additional Investment
Hongkong and Shanghai Banking Corporation, Hong Kong	Equator Trading Co.	04/05/85	Additional Investment
Citicorp, New York, NY	Citicorp International Trading Co.	04/09/85	Additional Investment
State Street Boston Corp., Boston, MA	State Street Trade Development Co., Inc.	07/29/85	Additional Investment
Citicorp, New York, NY	Citicorp International Trading Co.	11/08/85	Invest in Bonded Collateral Management Vehicle
State Street Boston Corp., Boston, MA	State Street Trade Development Co., Inc.	12/19/85	Additional Investment
Chase Manhattan Corp., New York, NY	Chase Trade, Inc.	02/26/86	Increase Leveraging[3] to 17:1
Ramapo Financial Corp., et al., Wayne, NJ	Bancorps' International Trading Co.	05/12/86	Additional Investment

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[1] In each instance, the Federal Reserve had no objection to the proposal.

[2] In its notification to the Board to establish its ETC, Security Pacific sought to engage in only limited ETC activities. The purpose of this notification was to enable it to engage in the full scope of the activities permitted under the BESA.

[3] Technically, this request was for relief from a commitment, not an ETC notification.

Senator HEINZ. Dr. Johnson, thank you.

Senator Mattingly, do you have an opening statement you would like to make?

STATEMENT BY SENATOR MACK MATTINGLY

Senator MATTINGLY. Thank you, Mr. Chairman. I would like to commend the Senator from Pennsylvania for holding this hearing on S. 1934. Like you I had what I thought were reasonably optimistic expectations of the Export Trading Act of 1982. I did not expect, as Secretary of Commerce Baldrige put it, "People lined up for 5 blocks" to apply for export trading company status, but I did think that we would see more enthusiasm. My concern is that the act itself, as currently administered, is an actual disincentive.

The purpose of the Export Trading Company Act is to make it easier for U.S. firms to enter foreign markets. ETC's, as they are known, provide one-stop export financing and marketing services. They also assume inventory and foreign exchange risks. They allow exporters to make deals through a single channel, especially important to small- and medium-sized businesses.

Of particular concern to me, Mr. Chairman, is the so-called 51-49 rule wherein a minimum of 51 percent of an ETC's business must be exporting. The formula used to calculate the percentage of export activity in effect penalizes an ETC that engages in that form of trade known as countertrade. Countertrade is vital to many export deals. While difficult to quantify, it is obvious that the volume of global countertrade is increasing. Why should we penalize the import portion of a countertrade transaction especially if the goods taken in exchange were not sold in the United States?

I look forward to hearing testimony from today's witnesses.

Senator HEINZ. Mr. Luft.

STATEMENT OF R. DAVID LUFT, DEPUTY ASSISTANT SECRETARY FOR SERVICES, DEPARTMENT OF COMMERCE

Mr. LUFT. Thank you, Mr. Chairman.

Mr. Chairman, members of the committee, I am pleased to have this opportunity to address the subcommittee for the Department of Commerce and for Assistant Secretary Goldfield, and report on the status of the Exporting Trading Company program and what might be done to improve it.

With your permission, I will submit my prepared testimony for the record and provide a summary.

Senator HEINZ. Without objection, your entire statement will be a part of the record.

Mr. LUFT. In carrying out its responsibilities under the Export Trading Company Act, the Department's Office of Export Trading Company Affairs is actively engaged in promoting the formation of export trading companies, providing advice and counsel to potential users of the act, maintaining a contact facilitation service, and processing applications for antitrust protection under export trade certificates of review.

The current status of the program and a summary of our promotional efforts are provided in my prepared testimony. I now wish to turn to our concerns with the Federal Reserve Board's title II regulations and our views on S. 1934.

DISAGREEMENT IN FIVE SPECIFIC AREAS

The Department of Commerce has often expressed its view that the regulations and administrative practices adopted by the Federal Reserve Board for its administration of the title II bank ETC Program are too stringent to permit bank ETC's to effectively compete head-to-head with foreign-owned ETC's. Disagreement with the Board's regulations and practices involve five specific areas.

One, limitations on the permissible activities of a bank export trading company;

Two, the method for calculating whether a bank export trading company has met the requirement of deriving more than one-half of its revenue in each consecutive 2-year period from export activities, otherwise known as the 50-percent revenue test;

Three, the general limitation of $2 million as the value of goods to which a bank export trading company can take title without first having a firm order for resale;

Four, limits on financial leveraging, and

Five, the application of section 23A of the Federal Reserve Act to bank export trading companies.

Commerce has previously made known its position on the need for changes with regard to the first three of these items. Secretary Baldrige and Chairman Volcker have twice exchanged letters on these issues.

Concern about the application of section 23A and the leveraging limitation has been expressed by representatives of the banking community as well as the Industry Sector Advisory Committee of Commerce and the U.S. Trade Representative.

Under a straightforward reading of the title II statutory language, a bank-owned export trading company may export its own goods and services or it may facilitate the export of goods and services produced in the United States by unaffiliated persons.

Under the Board's regulatory definition, however, a bank may not export its own goods and services but can only provide services to facilitate trade in goods and services produced by others.

We at the Department of Commerce take exception to the Board's reading of the statute. It should be noted that in its 1986 report on implementation of the act, the General Accounting Office supported Commerce's interpretation of the statute.

With regard to the 50-percent revenue test, the Department of Commerce does not disagree with the Board's rationale that a bank ETC must derive more than 50 percent of its revenues from export activities in order to be considered principally in the business of exporting. What the Department of Commerce is concerned about is the Board's method for calculating compliance with the 50-percent test.

Under the Board's current regulations, countertrade transactions and fees derived from facilitating third country trade are treated on the import side of the ledger for the purpose of the test—a method which the Department of Commerce views as a major disincentive to the formation of bank-owned ETC's and an impediment to their operation.

TAKING TITLE OF GOODS MORE FREELY

Finally, Commerce has expressed its disappointment that the bank affiliated export trading companies approved by the Federal Reserve Board have not been able to take title to goods more freely. Through its administrative practice of requiring Washington approval of any application proposing to hold inventory in excess of $2 million, the Board has effectively signaled prospective applicants to abide with the $2 million limitation.

Thus, unlike nonbank export trading companies and foreign-owned trading companies with ties to foreign banks, U.S. bank ETC's generally may not assume risk positions commonly accepted in international trade.

In addition to the concerns about the Board's regulations that we at Commerce have addressed, members of the banking community have voiced their disagreement with the Board's leveraging limitation and the applicability of section 23A to bank affiliated ETC's.

In contrast to the assets-to-equity ratio maintained by the Japanese sogo shosha, the maximum 10-to-1 ratio imposed by the Board is quite low. In a study prepared by one of this country's major accounting firms, only 2 of the 8 sogo shosha studied had leveraging ratios of less than 22 to 1 and half of them had an assets-to-equity ratio of 30 to 1 or more.

The proposed amendments to title II contained in S. 1934 address the five concerns that Commerce and the banking industry have with the Federal Reserve Board's regulations. The proposed amendments would make it clear that a bank export trading company could export its own services or those of its affiliates.

The amendments affecting leveraging requirements and the applicability of section 23A of the Federal Reserve Act appear to be consistent with the positions expressed by a significant number of bank ETC representatives.

However, because the Board's limitation on inventory is a result of administrative practices, the proposed amendment dealing with inventory might not achieve its desired result. Consideration should be given to removing any specific dollar limitation in the amount of inventory that can be held. The asset-to-equity ratio itself places a limit on borrowing capacity and consequently limits the amount of inventory that can be purchased with borrowed funds. This approach would be preferable to a specific dollar limit on inventory which has the disadvantage of making no distinction between large and small bank export trading companies.

Last, the amendments would provide that to meet the revenue test a bank ETC's revenue from exporting U.S.-produced goods and services and providing export facilitation services must exceed its revenues derived from importing into the United States.

While this represents a major improvement in the application of the test, we note that it does not credit the bank ETC with export revenue in those instances where payment is made in a form other than currency.

Also, this amendment would exclude revenue derived from facilitating third country trade from the calculation. Servicing third country trade activity is an export of a bank ETC's services. The revenues earned from providing such services should logically be counted as export revenues.

Although we believe there might be some benefit to considering modifications to S. 1934 along the lines I have outlined, I wish to emphasize that even without any such changes S. 1934 should go a long way in improving the operating environment for existing bank ETC's and will likely encourage the formation of new bank ETC's.

We are now at an important juncture of the program. The suggested improvements to title II of the act are critical if we are to achieve the goals envisioned at the time of the original passage.

Thank you, Mr. Chairman.

[The complete prepared statement follows:]

Prepared Statement of R. David Luft
Deputy Assistant Secretary for Trade Development
International Trade Administration
U.S. Department of Commerce

Before the
International Finance and Monetary Policy
Subcommittee
of the
Committee on Banking, Housing and Urban Affairs

June 17, 1986

Introduction

Mr. Chairman and members of the Committee, I am David Luft, Deputy Assistant Secretary for Services, International Trade Administration, U.S. Department of Commerce. I am pleased to have this opportunity to address the Subcommittee and report on the status of the Export Trading Company program, and what might be done to improve it.

The Export Trading Company Act of 1982 seeks to increase U.S. exports by encouraging more efficient provision of export trade services to domestic producers and suppliers, improving the availability of trade finance, and removing antitrust risks for export activities. The Department of Commerce is the lead Federal agency responsible for implementing the Act. In carrying out its responsibilities the Department's Office of Export Trading Company Affairs (OETCA) is actively engaged in promoting the formation of export trading companies, providing advice and counsel to potential users of the Act, maintaining a contact facilitation service, and processing applications for antitrust protection under export trade certificates of review. The Federal Reserve Board is responsible for administering that portion of Title II of the Act that permits bank holding companies and certain other eligible financial institutions to own all or any part of an export trading company.

Status of the Program

As of June 10, 1986, the Department of Commerce has issued 65 certificates of review under the Title III antitrust preclearance program. In addition, as of the same date 41 bank holding companies have notified the Federal Reserve Board of their intention to undertake equity investments in ETCs as provided for in Title II. According to a recent telephone survey conducted by the Department's staff 29 out of the 41 are operational or in a start-up phase.

In carrying out the Department's Title I promotional responsibilities, the OETCA has conducted a vigorous out-reach program to inform the business, legal, and financial communities about the benefits of the Act. For example, OETCA recently completed a schedule of nine FY 86 conferences that were cosponsored with the Department's district offices throughout the country. This was the latest of a series of outreach activities conducted by OETCA in cooperation with other government agencies and private sector organizations. In addition, the Department has engaged in numerous presentations to trade groups, agricultural interests, and public sectors organizations on the Export Trading Company Act.

Although Commerce does not administer the Title II bank ETC program, it has, and will continue, to promote actively the formation of bank-affiliated export trading companies. Specifically, this fall we will conduct our fourth bank ETC conference. The purpose of these conferences is to bring government officials together with representatives of the banking community to explore business opportunities available through the ETC Act and to provide a forum for the discussion of regulatory concerns. The Federal Reserve Board and the Export-Import Bank have been active participants in these conferences.

We have greatly expanded the Contact Facilitation Service database, and later this summer we will be publishing the second edition of the CFS directory. The Contact Facilitation Service is a program designed to facilitate contact between U.S. producers of goods or services and firms offering export trade services. The new edition of the directory will contain the names of more than 4500 U.S. producers and trade facilitation firms.

Title II -- Bank Export Services Act

The Department of Commerce has often expressed its view that the regulations and administrative practices adopted by the Federal Reserve Board for its administration of the Title II bank ETC program are too stringent to permit bank ETCs to effectively compete head-to-head with foreign owned ETCs. On two occasions -- September 21, 1983 and September 13, 1984 -- Secretary Baldrige wrote Chairman Volcker requesting the Board's cooperation in modifying its Title II regulations to provide broader powers to bank ETCs. More recently the Industry Sector Advisory Committee for Services (a private sector panel established by Congress to advise Commerce and USTR on trade issues) expressed strong support for changes in the Board's regulations, and specifically requested Commerce to convey the ISAC's views to the Federal Reserve Board. Industry dissatisfaction with the regulations is also discussed in the recently issued report of the U.S. General Accounting Office entitled "Implementation of the Export Trading Company Act of 1982". Commerce has expressed its agreement with the general conclusions reached in that study.

Disagreement with the Board's regulations and practices involve five specific areas: (1) limitations on the permissible activities of a bank ETC; (2) the method for calculating whether a bank ETC has met the requirement of deriving more than one-half of its revenue in each consecutive two-year period from export activities (the "50 percent revenue test"); (3) the general limitation of $2 million as the value of goods to which a bank ETC can take title without first having a firm order for resale; (4) limits on financial leveraging; and (5) the application of Section 23A of the Federal Reserve Act to bank ETCs. Commerce has previously made known its position on the need for changes with regard to the first three of these items. Concern about the application of Section 23A and the leveraging limitation has been expressed by representatives of the banking community and ISAC-13.

Limitations on Permissible Activities

Under a straightforward reading of the Title II statutory language, a bank ETC may export its own goods and services, or it may facilitate the export of goods and services produced in the United States by unaffiliated persons. Under the Board's regulatory definition, however, a bank may not export its own goods and services but can only provide services to facilitate trade in goods and services produced by others. Thus, under the Board's regulatory definition a bank ETC can not have an equity interest in a U.S. company that exports its construction management services for overseas projects. We take exception to the Board's reading of the statute. Title II makes clear that a bank ETC may not engage in agricultural production or in manufacturing, but the Board's regulatory definition has extended the scope of prohibited activities to include any service that is not strictly an export trade facilitation service. It should be noted that in its 1986 report on implementation of the Act, the General Accounting Office supported Commerce's interpretation of the statute.

Application of the 50 Percent Revenue Test

With regard to the 50 percent revenue test, the Department of Commerce does not disagree with the Board's rationale that a bank ETC must derive more than 50 percent of its revenues from export activities in order to be considered "principally" in the business of exporting. What Commerce is concerned about is the Board's method for calculating compliance with the 50 percent test. Under the Board's current regulations countertrade transactions and fees derived from facilitating third country trade are treated on the import side of the ledger for the purpose of the test.

It is Commerce's view that, for purposes of the 50 percent test, any transaction that involves the sale of U.S. goods or services overseas should be considered an export regardless of the method of payment. Also, revenues in the form of fees from facilitating a third country transaction where goods or services do not enter the U.S. should be treated as derived from the export of a service.

Limitations on Inventory

Finally, Commerce has expressed its disappointment that the bank-affiliated ETCs approved by the Federal Reserve Board have not been able to take title to goods more freely. Through its administrative practice of requiring Washington approval of any application proposing to hold inventory in excess of $2 million, the Board has effectively signaled prospective applicants to abide with the $2 million limitation. Thus, unlike non-bank ETCs and foreign owned trading companies with strong ties to foreign banks, U.S. bank ETCs generally may not assume risk positions commonly accepted in international trade.

Leveraging and Section 23A

As I have noted earlier, both the banking community and ISAC-13 have voiced their disagreement with the Board's leveraging limitation and the applicability of section 23A to bank-affiliated ETCs. In contrast to the assets-to-equity ratio maintained by the Japanese sogo shosha, the maximum 10:1 ratio imposed by the Board is quite low. (As with inventory, the Board's administrative practice requiring Washington approval of any proposed ratio greater than 10:1 signals applicants to remain within the 10:1 ratio.) In a study prepared by one of this country's major accounting firms only two of the eight sogo shosha studied had leveraging ratios of less than 22:1 and half of the companies had an assets-to-equity ratio of 30:1 or more. According to a companion study, although the sogo shosha operate on margins as low as 1-2%, they remain financially sound in part because of bank support of their highly leveraged positions. This high leverage enhances the ability of the company to realize an adequate return on equity. This same study also notes that European trading companies tend to operate with lower leverage ratios than the large Japanese companies.

Section 202 of the Export Trading Company Act makes it clear that the purpose of Title II is to provide for "meaningful and effective participation by bank holding companies, bankers' banks, and Edge Act corporations, in the financing and development of export trading companies in the United States." In furtherance of this purpose, Congress declared its intention that the Federal Reserve Board should pursue regulatory policies that provide for the establishment of export trading companies with powers sufficiently broad to enable them to compete with similar foreign owned institutions. Our bank ETCs do not currently have those powers. Within every banking organization a bank ETC will have to compete for funds and support. Unless it can become a profit center and compete effectively within the organizational structure it will cease to exist. The current regulatory environment imposed by the Board is inhibiting bank ETCs from becoming effective competitors. Legislative changes in the five areas noted above will likely have a significant positive impact on the international trade activities of several existing bank ETCs and encourage the formation of additional bank ETCs.

The proposed amendments to Title II contained in S. 1934 address the five concerns that Commerce and the banking industry have with the Federal Reserve Board's regulations. The proposed amendments would make it clear that a bank ETC could export its own services or those of its affiliates. A bank ETC would, of course, continue to be prohibited from engaging in agricultural production or manufacturing.

The amendments affecting leveraging requirements and the applicability of section 23A of the Federal Reserve Act appear to be consistent with the positions expressed by a significant number of bank ETC representatives and the ISAC. However, because the Board's limitation on inventory is the result of administrative practices, the proposed amendment dealing with inventory might not achieve its desired result. In the April 29, 1986 letter from Chairman Volcker to Congressman Don Bonker, the Chairman states:

> The draft bill would prohibit the Board from imposing a dollar limit on the amount of goods that ETCs may maintain in inventory other than on a case-by-case basis. In fact the Board currently employs such a case-by-case approach so the amendment to the BESA is unnecessary. No problems would be presented by a clarification of the statute.

This response reinforces the concern that, even with the amendment, the Board will continue its current practice. Consideration should be given to removing any specific dollar limitation in the amount of inventory that can be held. The asset-to-equity ratio itself places a limit on borrowing capacity, and consequently limits the amount of inventory that can be purchased with borrowed funds. This approach would be preferable to a specific dollar limit on inventory which has the disadvantage of making no distinction between large and small bank ETCs.

Lastly the amendments would provide that, to meet the revenue test, a bank ETC's revenue from exporting U.S. produced goods and services and providing export facilitation services must exceed its revenues derived from importing into the U.S. While this represents a major improvement in the application of the test, we

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note that it does not credit the bank ETC with export revenue in those instances where payment is made in a form other than currency. Also, this amendment would exclude revenue derived from facilitating third country trade from the calculation. Servicing third country trade activity is an export of a bank ETC's services. The revenues earned from providing such services should logically be counted as export revenues.

Conclusion

Although we believe there might be some benefit to considering modifications to S:1934 along the lines we have discussed, I wish to emphasize that even without any such changes S:1934 should go a long way in improving the operating environment for existing bank ETCs and will likely encourage the formation of new bank ETCs. The Department of Commerce has been diligent in promoting the formation of export trading companies and utilization of the ETC Act. We are now at an important juncture of the program. The suggested improvements to Title II of the Act are critical if we are to achieve the goals envisioned at the time of passage.

Senator HEINZ. Mr. Luft, thank you very much.
Mr. Mendelowitz.

STATEMENT OF ALLAN I. MENDELOWITZ, SENIOR ASSOCIATE DIRECTOR, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION, GENERAL ACCOUNTING OFFICE

Mr. MENDELOWITZ. Thank you, Mr. Chairman. I'm happy to be here today to discuss GAO's recent work on the progress made in implementing the Export Trading Company Act. My full statement, which I will submit for the record, summarizes the information in our report dated February 27, 1986.

Senator HEINZ. Without objection, your entire statement will be made a part of the record.

BUSINESS RESPONSE SLOW

Mr. MENDELOWITZ. As we know, thus far business response to the act has been slow. Only 62 export trading companies have received antitrust clearance certificates from Commerce and only 40 bank holding companies have received Federal Reserve Board approval to invest in ETC's. And out of those 40, 11 are not active, having been either sold, deactivated, or in fact never having achieved organizational and operating status.

Generally, exports facilitated through ETC's have not been significant.

When we contacted the ETC's, and especially the bank ETC's, they raised a number of concerns about Federal Reserve Board regulations. They believed that certain provisions of the act and Federal Reserve Board regulations and policies have affected or will affect their export performance, potential to compete with foreign-owned trading companies and ability to survive.

Of particular concern are the Board provisions that bank ETC's: One, must derive more than 50 percent of their revenue from exporting with third-country trade and countertrade counted as non-export revenue; two, they cannot invest in firms that themselves export services; three, they must observe the same collateral requirements as nonbank affiliates when borrowing from the parent bank; four, they are discouraged from having a leveraging or asset-to-capital ratio greater than 10 to 1, thereby limiting the amount that can be borrowed; and five, they must have proposals to take title to goods in excess of $2 million except against firm orders approved by the Federal Reserve Board.

In our opinion, all five provisions place bank ETC's at a competitive disadvantage with nonbank ETC's and foreign trading companies and we believe that the provisions of your legislation will go a long way toward addressing the disabilities that the banks informed us about.

With respect to the exporting requirement—the measure of whether the export trading company is principally involved in exporting—we believe that under the act the Federal Reserve Board has considerable latitude to come up with measures that are less burdensome than the measure currently adopted by the Fed; and because they are reluctant to come up with less burdensome measures, we support the provisions of S. 1934 that would change the way in which principally for export is determined based upon comparing export revenues to import revenues.

In addition, with respect to exporting services, we believe that a clear reading of the act permits a bank holding company to invest in an export trading company that exports its own services.

Because the Federal Reserve Board is very strongly opposed to permitting this, we believe that the definition of an export trading company in S. 1934 is needed and is so explicit that, if enacted, the Board would no longer maintain that an export trading company cannot export its own services or services of its affiliates.

This concludes the summary comments I choose to make at this time and I'd be happy to try to respond to any of your questions.

[GAO report "Implementation of the Export Trading Company Act of 1982," may be seen in the subcommittee files.]

[The complete prepared statement follows:]

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C.

FOR RELEASE ON DELIVERY
EXPECTED AT 9:30 a.m.
JUNE 17, 1986

STATEMENT OF

ALLAN I. MENDELOWITZ
SENIOR ASSOCIATE DIRECTOR, NATIONAL SECURITY
AND INTERNATIONAL AFFAIRS DIVISION

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE
AND MONETARY POLICY
SENATE COMMITTEE ON BANKING, HOUSING,
AND URBAN AFFAIRS

ON

IMPLEMENTATION OF THE EXPORT
TRADING COMPANY ACT OF 1982

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our recent work on the progress made in implementing the Export Trading Company Act of 1982. My statement summarizes the information discussed in our report dated February 27, 1986, and provides some observations we have made based on our work.

OVERVIEW

During deliberations on how to increase exports, Congress concluded that potential exports were not being realized due to a number of factors, including a lack of business expertise in exporting, limited financing, and government regulations. Congress believed that to reach a significant number of potential exporters, well-developed export trading companies (ETCs) were needed to provide a full range of trade services and to achieve economies of scale in order to lower unit costs. Congress expected that ETCs could be more successful if they were allowed to draw upon the financial resources and expertise of the banking system. It also believed that reducing the antitrust issue as an impediment to export trade would be helpful.

The Export Trading Company Act was passed on October 8, 1982, and includes provisions regarding all of these points. It sets out to increase exports of products and services by (1) providing for the formation of an Office of Export Trading Company Affairs in the Department of Commerce to promote and encourage the formation of ETCs, (2) allowing bank holding companies to invest in ETCs, (3) reducing restrictions on trade financing, and (4) modifying the application of antitrust laws to export trade and providing for Commerce to issue certificates of review for specific antitrust protection.

Thus far, businesses' response to the Act has been slow. Only 62 ETCs have received antitrust clearance certificates from Commerce. And, only 40 bank holding companies have received Federal Reserve Board approval to invest in ETCs. Similarly, exports facilitated through ETCs have not been significant. According to the banks and ETCs we visited, the economic conditions of the past few years, particularly the high value of the dollar against the currencies of foreign countries, has hampered exporting by those ETCs which have been established. Yet, in our opinion, bankers and exporters have an increased awareness of export trading and are in a position to take greater advantage of it as economic conditions become more favorable. The increased awareness toward exporting could result in the formation of more ETCs and, eventually, in increased export trade.

We believe, however, that it would be unrealistic to expect that removal of export barriers in and of themselves would yield a major increase in exports, since U.S. export performance is determined by many variables, including the level and growth of gross national product in foreign countries; the value of the dollar; the availability of international lending and the current developing country debt problems; U.S. technological leadership; foreign tastes and preferences for and barriers against U.S. products; U.S. business attitudes; and impediments to U.S. exports created by U.S. laws and regulations. The most important determinants are fundamental economic factors, such as foreign economic growth and relative exchange rates.

COMMERCE'S OFFICE OF EXPORT TRADING COMPANY AFFAIRS

Pursuant to Title I of the Act, Commerce established the Office of Export Trading Company Affairs (OETCA) to promote and encourage the formation of ETCs and to facilitate contact between producers of exportable goods and services and firms offering export services. For fiscal year 1986, OETCA has a budget of $746,000 and has been authorized 17 people (12 professionals and 5 secretaries) to carry out both Title I ETC promotion and Title III certificate of review efforts.

Initial Commerce promotion efforts informed the public about the Act through a number of conferences held throughout the country and through publications, such as The Export Trading Company Guidebook and the Contact Facilitation Service Directory which lists by state both the export service providers and U.S. producers of goods and services that want to be registered. During fiscal year 1985 and through fiscal year 1986 to date, promotion activities have consisted of (1) conducting, co-sponsoring, or participating in over 25 promotional events, such as bank and agribusiness ETC conferences, and (2) distributing brochures and articles and updating the Directory.

As noted in our report, there is no data available on the success of these promotion efforts in bringing producers and ETCs together or on the number of ETCs formed as a result of the promotion efforts.

CERTIFICATES OF REVIEW

Under Title III, any person or firm may request the Department of Commerce to determine in advance whether its export conduct qualifies for specific antitrust protection. To date Commerce, in conjunction with the Justice Department, has issued antitrust certificates of review to 62 organizations (including 32 newly organized ones) extending antitrust protection for their export activities. These certificates also extend antitrust protection to the export trade activities of about 263 firms and individuals participating in the certificates.

Twenty-nine of the firms provide export services to facilitate the sale of goods and services of non-affiliated firms in export markets, and 33 of them or their members produce at least some of the goods or services that are exported.

The type of export conduct certified can be classified as horizontal or vertical. Horizontal arrangements are those in which domestic competitors have joined together to fix prices and allocate markets, customers, or quotas--28 certificates have been granted for which the antitrust issues were principally horizontal.

Vertical arrangements are restrictive agreements with U.S. suppliers of export products or distributors in export markets. They can be non-exclusive or exclusive agreements where the ETC can refuse to deal with other U.S. suppliers or other distributors in export markets--32 certificates have been granted for which the antitrust concerns were principally vertical. There were no antitrust issues for the remaining two certificate holders.

The 62 certificate holders are geographically disbursed, with 8 in the Northeast, 26 in the South (including several in Washington, D.C.), 16 in the Midwest, and 12 in the West. These firms handle a wide variety of products, as shown in appendix II to our report.

Many of the firms we contacted clearly had not done as well as they had hoped. Since the data collection for our report was completed several months ago, we contacted 18 of the 23 firms we had previously contacted and learned that they were still not doing as well as anticipated. Six did report an increase in exports this past year, but 10 reported decreases, and 2 reported no change. They continue to believe that the value of the dollar had been their major problem, but also still cite availablity of financing as a problem.

The annual reports filed this past year with OETCA by the certificate holders show that some have done no exporting. Of the 40 firms who reported, two went out of business and 14 were in the process of getting organized and initiating business activities. The remaining 24 firms reported a total of about $60 million in export sales. Most of these firms, or their members, were exporting before obtaining certificates from OETCA. For example, one of these firms by itself accounted for a third of the reported exports and the three largest firms accounted for 69 percent.

Only 26 of the 40 firms voluntarily reported the number of employees engaged in exports--and most had 5 or less employees.

Some reasons why more businesses have not sought certificates of review

Commerce states that one reason for the low number of certificates of review is because Title III is a new process. A company must provide proprietary business data to the Commerce and Justice Departments and may want to know that the benefits are worth doing so. A second reason may involve the lack of antitrust issues; many applications were withdrawn because the firms did not have antitrust issues--they did not handle competing products, had no need to fix export markets or prices, or did not want to combine with others for this purpose. The executive director of a trade association also told us that more companies have not applied for certificates because most companies are specialized and have such small shares of the market that they do not see themselves in potential violation of the antitrust laws.

Other reasons why so few businesses have sought the certificates might be that (1) antitrust restrictions are not perceived to be a barrier to exporting or (2) businesses may be relying on the protection under Title IV of the Act, which clarified the antitrust laws in regard to export trade. Commerce has emphasized that Title IV may have reduced antitrust uncertainty and noted that the extent of its impact on increased exports cannot be determined.

BANK HOLDING COMPANY INVESTMENT IN ETCs

Title II permits bank holding companies, under the review and supervision of the Federal Reserve Board, to invest in ETCs. The Board gave approval to bank holding companies to form 40 bank ETCs; 30 of them are wholly-owned subsidiaries of the bank holding companies, two are subsidiaries of bank holding companies but allow other investors, and 8 are joint ventures.

The bank ETCs are geographically disbursed--13 in the Northeast, 11 in the West, 6 in the Midwest, 9 in the South, and one overseas. The total authorized investment in the 40 companies is about $84 million, ranging from a high of $18 million to a low of $10,000.

As shown in table 1, the size of the bank holding companies which invested in the ETCs varies considerably. Nine multinational money center banks, accounting for 10 ETCs, represent 84 percent of the approved investments.

Table 1

Size of Bank Holding Companies and Their Investments in ETCs

Size of bank holding company	Number of ETCs	Total approved investment	
		Amount (thousands)	Percent
Money center banks	10	$71,103	84
Assets over $5 billion	13	6,573	8
Assets between $1 billion and $5 billion	5	3,250	4
Assets below $1 billion	8	1,275	2
Joint venture of three banks	2	702	1
Dissolved ETCs	2	1,150	1
Total	40	$84,053	100

At the time of our survey, most of the bank ETCs were in the formative stages of getting organized and identifying markets and customers. The eight that we visited reported only limited exports.

Since the data collection for our report was completed several months ago, we updated our information. Of the eight bank ETCs we visited earlier, only two reported no change in operations or key personnel; four had major changes in the ownership or operations; and two had changes in key personnel.

In December 1985, one bank holding company sold its ETC to its managers; a second ETC, organized as a full service trading company, had been reduced in size from about 40 employees to 4 and is now active only in trade financing; a third, which represented small to medium sized U.S. companies in overseas markets, principally China, decided to disband the company in late January 1986; and the fourth, although still functioning the same as before, has now merged with a trade development group in the parent bank to create a new bank ETC. Regarding the two ETCs which have had changes in personnel, one has changed presidents and the other continues to provide trade development services on a contracting-out basis but no longer has any staff--its services are integrated with the bank and provided by bank employees.

Some reasons why more bank holding companies have not invested in ETCs

More bank holding companies have not invested in ETCs for such reasons as (1) they do not service many exporters, (2) they

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believe that ETCs should be undertaken only by large international banks, or (3) they believe the profitability of an ETC is too uncertain and find other areas of banking more profitable.

--One bank, for example, advised us that capital is needed for its lending activities. Export trading is a new area where margins are small, and an ETC will be formed only if it appears more attractive than other business areas.

--Another stated that it can encourage trade and meet the needs of its clients without establishing an ETC. Its clients are large multinational companies experienced in exporting.

--A third said that it does not need to form an ETC to provide its clients with expertise in exporting. It believes that the potential constraints on its capital and the strength of the U.S. dollar made a poor climate for exporting.

CONCERNS ABOUT FEDERAL RESERVE BOARD REGULATIONS

Bank ETCs we surveyed believe that certain provisions of the Act and certain Federal Reserve Board regulations and policies have affected or will affect their export performance, potential to compete with foreign-owned trading companies, and ability to survive. Of particular concern are the Board provisions that bank ETCs (1) must derive more than 50 percent of their revenue from exporting, with third-country trade and countertrade counted as non-export revenue, (2) cannot invest in firms that themselves export services, (3) must observe the same collateral requirements as non-bank affiliates when borrowing from parent banks, (4) are discouraged from having a leveraging, or asset-to-capital, ratio not greater than 10 to 1, thereby limiting the amount that can be borrowed and (5) must have proposals to take title to goods in excess of $2 million (except against firm orders) approved by the Federal Reserve Board. The Federal Reserve Board has emphasized to us that it promulgated its regulations to reflect a congressional concern for the balance between bank participation in ETCs and fundamental concerns about assuring the safety and soundness of banks.

We are sensitive to the concerns reflected in these provisions that bank investment in ETCs conform to standards of banking and financial prudence. In our opinion, however, all five provisions place bank ETCs at a competitive disadvantage with non-bank ETCs.

Exporting Requirement - The Act requires a bank ETC to be operated principally for the purpose of exporting; the Board's test for this requirement is that more than 50 percent of total revenue--including exports, imports, and the sale of foreign products in overseas markets--must come from exporting over a 2-year period. The proceeds of countertrade and trade that the ETCs arrange between two foreign countries are counted as non-export revenue. The bank ETCs argue that if half of the business must consist of exports, they may not be able to meet the Board's requirement. They assert that, as a minimum, the 50-percent requirement should encompass more than a period of 2 years and that a transaction necessary to make an export sale should not be counted as non-export revenue. For example, the element of a countertrade transaction involving a third country should not be counted as non-export revenue.

The Board views its 50-percent requirement as assuring that the legislative intent is carried out. Importing is less difficult, and the Board feels that without the 50-percent export requirement, bank ETCs would have less incentive to find markets for U.S. goods. The Board is reluctant to take what it feels would be a stance against the export intent of the legislation. Board representatives advised us that ETCs which have commented on the regulation stated that the problem is anticipatory; they have had no difficulty meeting the test to date.

We believe the Board is clearly authorized to establish the 50-percent export requirement. The term "principally" in the context of the statutory provision contemplates that the preponderance of an ETC's activity will not be imports, and the legislative history, at least on the House side, anticipates the Board's measuring an ETC's activities in terms of revenue shares. Therefore, the Board acted within its authority by defining "principally" only in terms of export revenues and in setting the requirement that exports be more than 50 percent of all revenues.

The statute, however, does not itself address how such revenues should be calculated or whether revenue should be the sole basis for determining if an ETC is organized and operated principally for the purpose of exports. In fact, it does not even include the term "revenue". Therefore, in setting the

50-percent requirement, we believe the Board could redefine its own term "revenues" to include only proceeds from imports to and exports from the United States. This change would ordinarily exclude, for purposes of establishing whether an ETC meets the 50-percent requirement, the proceeds from foreign products sold in overseas markets that do not enter U.S. commerce. The Board could also devise indices additional to "revenue" to determine whether a company is "organized and operated" principally for exporting or for facilitating exports and it could extend beyond 2 years the period during which qualifying revenues are computed. We believe modifications along these lines could be framed to have the effect of reducing the extent to which companies view the current regulation as a potential impediment to operations and still assure that exporting would be the paramount ETC activity.

In a letter to us dated April 21, 1986, the Board reiterated its (1) position on determining whether an ETC is organized principally for export and (2) belief that excluding revenues from third-country trade would allow, and likely result in, ETCs owned by banking organizations engaging in activities unrelated to exports. However, the Board offered no evidence to support its opinion that such a "worst case" outcome is likely. And, we have seen no evidence that would lead us to conclude that this is likely to happen. We do not believe that it is required or desirable for the Board to retain this restrictive regulation that may discourage the formation and limit the commercial vitality of bank ETCs.

S.1934, the "Export Trading Company Amendments Act of 1985," would make changes to address this and other matters. For computation of the Board's 50-percent requirement, the bill proposes to amend the Act to qualify a company as an ETC when its export revenues exceed its import revenues; this would exclude from the calculation of revenues those third-party transactions involving neither exports to nor imports from the United States. We support this change.

Exporting of services - According to the Act's definition, a bank ETC is a company which is principally organized and operated for either of two purposes. It may itself export goods or services produced in the United States or it may facilitate the export of goods or services produced in the United States by unaffiliated persons by providing one or more export trade services.

Under the Board's definition, however, an ETC can provide services only to facilitate the export trade of others. Thus, a bank may not invest in an ETC that itself exports services to foreign customers. The Department of Commerce disagrees with the Board's position on this and correspondence has been exchanged about the matter between the Secretary of Commerce and the Chairman of the Board of Governors of the Federal Reserve System. The Board reasoned that its position that banks ETCs serve only as trade facilitators, not as investors in service industries, is sufficiently supported by the Act's purpose and legislative history.

Commerce contends that the regulatory definition of an ETC adopted by the Board is not supported by either the language of Title II or its legislative history. Instead, Commerce contends that a straightforward reading of the statutory definition clearly indicates that Congress intended an ETC to export goods or services itself or to facilitate the exports of goods or services of others by providing export trade services. Commerce concludes that the Board, by finding in the statutory language an "ambiguity" on which to base its interpretation, has merely established a vehicle to permit the Board to substitute its own view of the proper role for bank ETCs for the role Congress expressed in the statute and the legislative history.

A straightforward reading of the ETC Act's definition of "export trading company" permits bank holding companies to invest in an ETC which exports its own services. We think the Board is wrong in both its position that the definition is ambiguous, and its conclusion that the better interpretation is that an ETC can provide services only to facilitate the export trade of others. However, unless the pertinent statutory language is changed, the Board could continue to use this same justification for implementing its view of the statute. We note that Senator Heinz, in his introductory remarks to S.1934, clearly states his own belief, which we share, that the Board's interpretation of "export trading company" under the ETC Act is wrong. We believe that the new definition of "export trading company" in S.1934 is so explicit that, if enacted, the Board would no longer maintain that an ETC cannot export its own services or the services of its affiliates.

Mr. Chairman, this concludes my statement. I would be happy to respond to any questions you have at this time.

Senator HEINZ. Mr. Mendelowitz, thank you very much.

There are three areas that I think we ought to focus on where there's obvious dispute between you, Dr. Johnson, Mr. Luft, and Mr. Mendelowitz and the bill—3 to 1.

One is section 23A. The other is capital adequacy. The third is the exporting of services. All of you touched on them in your testimony.

One item that you left out of your spoken testimony, Mr. Johnson, was an experience that the Fed apparently had with respect to a specific case, on page 8 of your testimony, where you say that in one instance a bank lent to its affiliated ETC amounts in violation of section 23A without required collateral.

VIOLATION OF SECTION 23A

I would like to learn a little bit more about that example. How did you find out about the violation?

Dr. JOHNSON. I'm not sure I can expand in a lot of detail about the violation but, I assume it came through the examination process where it was determined that the bank did in fact lend in excess of the limitations. I think one obvious reason why it was found out was that the ETC got into economic difficulty. The ETC literally had major problems—survival problems—and ended up putting a lot of financial pressure on its parent bank. So because of this, the issue became highlighted.

Of course, this is one of the concerns that we have with banks owning ETC's if certain practices——

Senator HEINZ. I need futher explication of the example. Let me just ask you this. Was the loan in violation of both the Board's collateral requirements in section 23A and the ETC Act's limitation on loans to an ETC by its bank holding company?

Dr. JOHNSON. Just the collateral limitation.

Senator HEINZ. Just the collateral limitation. I gather that the ETC was unable to pay back the bank; is that right?

Dr. JOHNSON. That's right. It was unable to.

Senator HEINZ. Do we know why?

Dr. JOHNSON. I assume because its orders didn't come through; it was really not able to develop the business that it had proposed to. So because it didn't have sufficient earnings on its investment——

Senator HEINZ. How did that affect the condition of the bank?

Dr. JOHNSON. Well, it certainly put the bank at more risk. If it wanted to continue to support the ETC, it obviously would have to inject some——

Senator HEINZ. As a general rule, any investment that isn't as good as you planned on making it puts the bank at more risk. I'm not asking that.

I'm asking did this cause the bank to be graded in a different way by the Federal Reserve? Did the bank go into a more stringent supervisory category? What happened to the bank? Did it get in trouble as a result of this or not?

Dr. JOHNSON. Well, I don't know about its latest examination report. My understanding is it just simply had lower earnings as a result.

Senator HEINZ. But it didn't cause the bank to be classified in a different category?

Dr. JOHNSON. No. Of course, it may not have been examined thoroughly since that time, so the problem could end up affecting its composite rating.

Senator HEINZ. But as far as we know today, it didn't?

Dr. JOHNSON. As far as I know.

Senator HEINZ. And what action did the Federal Reserve Board take when it discovered this?

Dr. JOHNSON. I would say there was a letter of understanding submitted asking them to correct the violation. Of course, if that continued, then a cease and desist order would have to be issued.

Senator HEINZ. Do we know if the violation was willful or was it unintentional?

Dr. JOHNSON. No, I'm not aware. We don't really know. I assume it was unintentional.

Senator HEINZ. All right.

Now let me ask Mr. Luft a question. Mr. Luft, Dr. Johnson has made a case that if we retain the section in the bill on section 23A that gives the export trading companies the freedom to operate that the Fed is now denying them, that this will have very serious safety and soundness problems for the Fed in its supervisory responsibilities. How do you answer that?

Mr. LUFT. Thank you, Mr. Chairman. We at the Department do not see a high level of increased risk. As I stated in my testimony, the leveraging ratio in itself provides some limits on what a bank would be able to extend to its export trading company.

If I may be permitted a personal observation, I was a commercial banker active in international commercial banking for approximately 7½ years. I think that this is more a matter of supervision than one of regulation.

By means of increased supervision, the dangers that would come from such a thing, which I do not believe are substantial, could be avoided. Naturally, this has some resource implications. However, my dealings with foreign-owned trading companies, in particular the Japanese ones, lead me to believe that they are quite capable through internal management techniques of operating with much fewer constraints than our companies do.

In fact, our companies are at a competitive disadvantage vis-a-vis the foreign owned ones in this regard.

Senator HEINZ. Thank you.

Let me ask Mr. Mendelowitz a question. Mr. Mendelowitz, Dr. Johnson makes the safety and soundness argument against, well, really all of the three provisions that we are discussing.

The GAO is uniquely qualified to assess what is and is not sound in terms of accounting and, by extension, perhaps what is and is not relatively safe in terms of risk.

Can you respond to Dr. Johnson's concerns?

SAFETY AND SOUNDNESS ISSUE

Mr. MENDELOWITZ. I think that with the passage of the Export Trading Company Act a statement was made by the Congress that in their judgment it was permissible to trade off some modest level of concern about the safety and soundness of banking in return for the benefits to the economy from the export performance that was hoped would ensue from the passage of the Export Trading Company Act and bank involvement in export trading companies.

The way the regulations have been written, there has been, I think, very little increased risk to banks from the activities of the export trading companies that they currently have invested in. So really what you're talking about is conflicting national priorities and in essence what you're talking about is the extent to which you are willing to trade off some modest increased risk to the banking system for improved export performance.

Senator HEINZ. You say the increased risks to the banking system are modest. I happen to agree with you. Why are they modest?

Mr. MENDELOWITZ. I think that the restrictions on the amount of capital that a bank holding company can invest in an export trading company and the restrictions on the amount of lending that a bank is permitted to make to any one borrower in essence insulate a bank holding company from any major risk associated with the activities of its bank export trading company.

Senator HEINZ. Dr. Johnson, what Mr. Mendelowitz is saying is that banks have legal investment and lending limits with regard to export trading company affiliates. They are spelled out in the law. Yet, they are also being subject to the very restrictive collateral requirements of section 23A.

Why do we need both, if you have the very strict investment limitations that we put in the statute precisely for that purpose?

Dr. JOHNSON. I know this sounds like a "Johnny-one-note" answer, but I think that there are some concerns with the integrity of the rules on bank affiliates in terms of safety and soundness. I hate to keep getting back to it—but it is I think the most important issue at stake here. Because the banking sector provides a major social service, depositors are protected and banks have a safety net through the discount window with the Federal Reserve. Thus, there is to a degree Federal subsidization of risk taking by banking institutions.

That really is what leads to the supervisory requirements that an organization affiliated with a bank has to meet similar regulatory standards. Because there is a Federal financial safety net provided to the banking industry, and because of this subsidized risk taking, there is the potential that managers of banking institutions and their affiliates could step over risk bounds. I think that you have to maintain the integrity of these rules to protect against such risk.

Now we have granted waivers, Senator, on the collateral issue and I think we have tried to be reasonably flexible about this, and if an ETC were to apply to the Fed with a proposal that made it clear that it was undertaking a low-risk activity, I think that we would feel comfortable with granting waivers on the collateral requirements.

Senator HEINZ. You say that the Federal Government subsidizes risk taking by banks. That's probably true.

Is foreign lending risky?

Dr. JOHNSON. It's turned out to be fairly risky, yes. I would say that it depends on what kind of loan you make, but obviously any loan is potentially risky, and that's why we have capital requirements.

Senator HEINZ. Which is riskier, lending for the balance of payments of a country whose debt service ability depends solely on the performance in the marketplace of the price of one commodity, or lending or investing in a company owned and operated by Americans from Americans for the purpose of conducting export trading company business? Which is riskier?

Dr. JOHNSON. Well, I think, once again, traditional lending has the kinds of protective features associated with it that——

Senator HEINZ. I understand all that, but I asked a question.

Dr. JOHNSON. Well, first of all, it depends on the case-by-case situation. It's very difficult to judge.

Senator HEINZ. Well, there are a lot of cases where the debt service ability of an individual country first of all depends on their ability to export at a profitable or reasonable or some kind of price that they can make some money on—coffee, oil, copper, tin, diamonds, uranium, whatever it may be—and there are plenty of instances, too, where banks have lent—American banks that you say are subsidized—have lent for balance of payments purposes in situations just like that.

Maybe you feel uncomfortable answering my question.

Dr. JOHNSON. No.

Senator HEINZ. I don't blame you if that's the case.

Dr. JOHNSON. Senator, first of all, export trading companies can borrow from any nonaffiliated bank under whatever conditions they can negotiate in the market. It's really just the actual affiliation with a bank that's a problem. If any export trading company has a good proposal, they can approach any bank for loanable funds for that project.

I think our concern is a direct affiliation with a bank and the potential conflict and safety and soundness questions that are involved.

RISKY LATIN AMERICAN COUNTRIES

Senator HEINZ. Well, let me ask you this. Would you like to name one or two Latin American countries that are relatively risky to lend to right now, or would you rather not mention any names?

Dr. JOHNSON. I would rather not.

Senator HEINZ. Would you agree that there are several—not just the one immediately to our south—but that there are several that pose some substantial risk problems and there are probably others out there that we haven't quite as clearly identified that could get into some difficulty? Would you agree with that general statement?

Dr. JOHNSON. Yes.

Senator HEINZ. Does the Federal Reserve have any limit on how much of capital and surplus an individual bank can lend to, say, Mexico?

Dr. **JOHNSON**. Well, there are rules on lending limitations and concentration of assets. There are capital ratios that are required in any country lending as well as any other type of loans.

Senator **HEINZ**. Well, Senator Proxmire and I are the authors of the International Lending Supervision Act which we're going to hold a hearing on in 1 week. Senator Proxmire, as I know you want to do and I want to do—and you may have some administrative guidelines that you follow. They are not part of the statute. And last—and this is one of the purposes of the hearing—I was not aware that you had specific limitations on individual countries as a proportion of capital and surplus. Are you sure you do?

Dr. **JOHNSON**. Well, what I'm referring to is the fact that there are specific reporting requirements for country exposure.

Senator **HEINZ**. Reporting requirements?

Dr. **JOHNSON**. Yes.

Senator **HEINZ**. They are a little different.

Dr. **JOHNSON**. But, of course, our advice in a supervisory sense would be if a bank was overly concentrated in one particular country, that would certainly affect its potential rating.

Senator **HEINZ**. Is the Bank of America overconcentrated in Mexico?

Dr. **JOHNSON**. I would say it's got a fairly large portfolio of Mexican loans.

Senator **HEINZ**. Are you doing anything to them for being overconcentrated? Are they being punished?

Dr. **JOHNSON**. Well, I think that——

Senator **HEINZ**. Other than by the fact that they're there? [Laughter.]

Dr. **JOHNSON**. Well, I think certainly we're stressing capital adequacy in a case like that and loan loss reserving.

Senator **HEINZ**. And your advice in a hypothetical situation like that is to have them cut back on their loans?

Dr. **JOHNSON**. Well, if they meet the capital adequacy requirements we are not getting into trying to allocate credit for them. There's a certain amount of risk-taking that banks can undertake, but they have to meet certain safety and soundness rules.

Senator **HEINZ**. Isn't your advice, though, in fact, to a bank like the Bank of America which may be—may be overextended in one country to tell them to increase their capital?

S. 1934 PREVENTS BANKS GETTING OVEREXTENDED

Dr. **JOHNSON**. Well, I think that's safe to say, yes.

Senator **HEINZ**. Well, what we have in this legislation, I would submit, prevents even with the enactment of S. 1934 as it stands, prevents you getting into anything like what you have with individual banks being overextended with respect to any individual country. Why? Because there's a 5-percent limit on investment in an affiliate—a bank holding affiliated export trading company—a 10-percent limit of capital and surplus on any loans.

Now do you agree that that would clearly prevent the kind of problems that many large banks are having with respect to their international loans?

Dr. **JOHNSON**. I would say that's very useful, yes.

Senator **Heinz**. All right. I thank you very much for a very helpful response.

Senator Proxmire.

Senator **Proxmire**. Dr. Johnson, I understand you have to leave shortly so I'm going to ask you some quick questions first and I'll get them in as fast as I can.

As you note in your testimony, there are a couple of thousand nonbank affiliated ETC's in this country which help our manufacturers export an awful lot of goods.

During an April 22 hearing on the House side, Mr. John Bowles, speaking for the nonbank ETC's, said:

> The proposal in the Heinz bill to permit bank-controlled trading companies to leverage at 25 to 1 would create a competitive disparity and the bank-controlled ETC's would be able to drive the independent ETC's out of the marketplace.

Do you think that concern voiced by Mr. Bowles is a valid one?

Dr. **Johnson**. Well, I think it certainly is a good point because it's my understanding that the average capital ratios of nonbank affiliated ETC's is only about 2 or 3 to 1. In fact, nonbank affiliated ETC's have very low leveraging ratios and are trying to pursue reasonably prudent approaches to export trading activities. Allowing 25 to 1 leveraging to bank affiliates would put nonbank ETC's in a very difficult competitive situation.

Senator **Proxmire**. Now I understand that nonbank-owned ETC's often find it difficult to obtain financing from our banks because their business is considered so risky. There was testimony on this on the House side.

If this is true and if banks find it quite risky to lend to nonbank ETC's, why should Congress permit banks to be less stringent in lending to their affiliated ETC's? Any comment?

Dr. **Johnson**. Well, I think that's a good question. That's one of the reasons why we have tried to be reasonably careful but flexible at the same time in setting standards for bank affiliated ETC's. There is this potential for activities between a bank and its ETC affiliate that could present safety and soundness risks with respect to direct lending to an affiliate. That's why we do have section 23A in the Federal Reserve Act. So I think that we need to be very careful about this.

EXPANDED POWERS FOR OVERSEAS ETC'S

Senator **Proxmire**. Now as I read the legislation, it would permit a bank-owned export trading company to sell services abroad when the services are produced directly by the bank or its affiliates. It seems to me this language would permit a bank holding company to own and operate a U.S. insurance company or securities firm as long as all of the insurance products or securities services were sold outside the United States.

As you know, banks have lobbied the Congress long and unsuccessfully to obtain these powers. This bill would seem to give it to them under the cover of an export trading company, at least as far as international sales are concerned.

Once the framework was established, it would be but a small step to persuade Congress to remove the artificial barriers and allow their insurance or securities subsidiaries to sell to U.S. citizens.

Can you comment on the reach of this legislation?

Dr. **Johnson**. I think one of our big concerns is the fact that it would make it possible for the traditional separation of commerce and banking to actually break down for foreign operations. Of course, this then would allow ETC's to get into almost any of the nonbanking-related services that are currently disallowed under the Bank Holding Company Act in the United States.

This is an important question of comprehensive bank regulation, but I think that if it's going to be addressed it ought to be addressed directly through the Bank Holding Company Act itself rather than in this manner.

Senator **Proxmire**. Well, I hope we can call Senator Dodd's attention to that and other people who are very interested in that particular aspect.

It seems to me the legislation is even broader than permitting banks to engage in insurance or securities activities. It allows an export trading company to engage in any business—any business—for the purpose of producing exports.

Moreover, the export trading company could import an equivalent amount of goods or services produced abroad by an overseas subsidiary for sales in the U.S. market.

Thus, bank holding companies would be free to engage in virtually any activity from selling securities on the one hand to manufacturing steel and selling those products both in the United States and abroad.

Can you comment on that possibility?

Dr. **Johnson**. Well, once again, I think that's one of the concerns we have.

ENCOURAGED JOINT VENTURE ACTIVITIES

Now one of the things that we have allowed and that we encourage, and which can achieve some of the results that have been a concern to other members of this panel are joint ventures between purely commercial enterprises those producing nonfinancial goods and services—and bank affiliated ETC's.

We think that being able to facilitate the marketing of U.S. produced goods and services through these joint ventures can achieve what is being sought here without violating the standard limitations between commerce and banking.

Senator **Proxmire**. Thank you, Dr. Johnson. Dr. Johnson, I don't have any further questions. I know you have to leave. I have other questions for Mr. Mendelowitz and Mr. Luft.

Senator **Heinz**. Very well. Senator Proxmire, I have one or two questions for Dr. Johnson and then I'd be happy to recognize you at that point to continue your questioning.

Senator **Proxmire**. All right. Fine.

Senator **Heinz**. Dr. Johnson, with respect to the leveraged ratio, S. 1934 prohibits the Board from disapproving a bank's investment in an ETC solely on the basis of the ratio unless it were greater than 25 to 1.

You point out that many factors have to be taken into account. I don't disagree with that—the nature of business, the size of inventory, size of the investment in the ETC, and so forth.

Why is that different from what I'm saying; namely, that a single factor—in this case a specific leverage ratio—should not be disposited?

Dr. **Johnson**. I think the problem is that if you just have a standard 25-to-1 ratio it allows an ETC under any circumstances to leverage itself as much as 25 to 1. On a case-by-case basis you have to consider the special circumstances and the degree of risk-taking involved in the activity. So I think under a low-risk——

Senator **Heinz**. But the act wouldn't prohibit you from making judgments on a case-by-case basis. Hypothetically, if an export trading company had a 24-to-1 ratio and you looked at it and said, "Well, that's a pretty high ratio. We can't disapprove it just simply because of that, but it seems to us that all the eggs are in one basket and the basket has a hole in it and so forth, it's a very large investment, it's a maximum investment, maximum loan by the bank in this instance, and it's a commodity in which there's a lot of risk." You could find other factors that caused you to make a case-by-case decision if it was warranted.

Our problem is that it appears that the Fed is looking at anything over 10 to 1 and saying that's too risky irrespective of the merits, and that's our problem.

Why can't you turn it and look at it as I've just described?

Dr. **Johnson**. Well, I think our feeling is that we would rather keep these standards consistent and grant an exception when there is a particularly low-risk activity, rather than actually change the standard itself.

Senator **Heinz**. Don't you think that saying that if you're over 10 to 1 we're going to give you the Federal Reserve version of the third degree and you may or may not get a waiver, don't you think that sends a pretty chilling signal?

Dr. **Johnson**. Well, in fact we have granted a leveraging ratio of up to 17 to 1. I think we have been reasonably flexible in this area and I would hate to support an across-the-board standard of 25 to 1. I think that that kind of leveraging is extreme, especially relative to what nonbank affiliated trading companies are doing already now—they are really only leveraged about 2 or 3 to 1 as it stands now.

Now this is not to say that some additional leveraging couldn't take place to facilitate more export trade, but we think that as much as 17 to 1 is plenty adequate to deal with any problems which might exist.

Senator **Heinz**. Did anybody on the Board ever run an export trading company?

Dr. **Johnson**. Well, I haven't asked, but I'm not sure.

Senator **Heinz**. When you said that the Board feels it's adequate to run an export trading company, I had the impression there must be a lot of expertise there in that area.

Dr. **Johnson**. Maybe other people are hearing it, but we're not getting major complaints about our supervisory requirements. The banking industry, from my understanding, has been reasonably satisfied with our administration of the Export Trading Company Act.

Senator HEINZ. Mr. Mendelowitz, is that your finding?

Mr. MENDELOWITZ. I think that they have been satisfied with the processing of forms and documents associated with the petitions, but as we pointed out in our testimony and in our report, they do feel that the restrictions that S. 1934 is attempting to deal with do place them at a competitive disadvantage.

Senator HEINZ. I've got one last question for Dr. Johnson. We'll get you out of here almost on time.

EXPORT OF SERVICES

You made a point in your testimony on page 12 of objecting to an ETC's export of its own services and/or services by others, or both. And you go on to say that that wasn't intended by the original act and that you can't see any reason why this is going to benefit the U.S. trade or balance-of-payments position.

Isn't the export of services very important to our balance-of-payments position?

Dr. JOHNSON. Yes, but I think the point that I was trying to make there was that I don't think that export trading companies were intended to be direct competitors with other exporters. I think the way we view the export trading company is more as a facilitator of export trade by U.S. domestic firms and, in fact, we don't want them getting into export competition. We want them to facilitate the export trade of existing firms.

Now the other point about export of services directly from the ETC, it's not a hard and fast rule. In fact, we have a list and we have approved a number of export trading company services that are direct export services—consulting and other types of services. We have allowed export trading companies to actually deal in trades and we've even approved some warehousing activity.

But I think the concern is that if we make this a general principle, that we run the risk of ETC's getting into nonbanking activities abroad and end up locating abroad, selling nonbanking services, financial and commercial, directly to foreign customers.

Senator HEINZ. But aren't foreign banks engaged in all those things abroad?

Dr. JOHNSON. Well, some of them. Some foreign banks are, yes.

Senator HEINZ. Wouldn't you say that a lot of them are? Isn't merchant banking beyond the United States the rule rather than the exception?

Dr. JOHNSON. Well, I don't know if I would say it's the rule, but there's certainly a fair amount of it undertaken, yes.

Senator HEINZ. Just to wrap it up. I don't want to detain you further. I gather that your concern has to do with the fact that you are uncomfortable with the export trading companies that are bank affiliated getting into the export of services produced by others, but not for safety and soundness reasons. It has to do with competing overseas against people who may or may not now be competing overseas.

So it's a philosophical issue rather than a safety and soundness issue. Is that correct?

Dr. JOHNSON. Well, no, I wouldn't go that far. I would say I would have to look very carefully at the kind of deposit support structure and safety nets that financial services are given through their individual governments to say whether it's a safety and soundness question or a competitive issue.

Senator **Heinz**. But your objection is lodged on the safety and soundness that this is risky for them to export the services produced by others? I'm not saying that it's not impossible for a bank holding company to do something badly and get itself in trouble. I'm just trying to figure out whether you attach to the export of services produced by others a higher degree of risk in that export than the services produced by the export trading company. It's not easy for me to see the difference in terms of risk. Maybe you see something I don't see.

Dr. **Johnson**. The risk may not be any greater, but the point is that one is bank affiliated and the other is not.

Senator **Heinz**. All right. Then I think I understand. It's more a question of the separation between banking and commerce.

Dr. **Johnson**. That's correct.

Senator **Heinz**. As opposed to safety and soundness per se by getting into a riskier line of business?

Dr. **Johnson**. But I think my point is that export trading activities are in general riskier than banking-type activities.

Senator **Heinz**. Do you remember our discussion about foreign lending?

Dr. **Johnson**. Yes, yes. I said "in general."

Senator **Heinz**. Do you still want to stand by that statement?

Dr. **Johnson**. I still think that's a fair statement in general.

Senator **Heinz**. Well, let the record show that people should check back further in the record.

Dr. Johnson, I don't have any further questions for you.

Senator **Proxmire**. Dr. Johnson, before you go, I do have just one final question.

EXPOSURE TO 25-TO-1 LEVERAGING

Isn't it true that since the equity investment of a bank in an ETC can be 5 percent of the bank's capital, and you multiply that by a 25-to-1 leverage, it means the bank is exposed up to 125 percent of its capital since the market expects it to stand behind the debt of the ETC? So if the ETC fails completely, down goes the bank. Isn't that right?

Dr. **Johnson**. If it were leveraged to that degree and it failed, yes, that would more than likely cause the bank to fail.

Senator **Proxmire**. Thank you.

Senator **Heinz**. Mr. Johnson, thank you very much.

Senator **Proxmire**. I have a few questions for Mr. Luft and Mr. Mendelowitz.

Senator **Heinz**. Senator Proxmire.

Senator **Proxmire**. Mr. Mendelowitz, on page 12 of your testimony you mention the April 21, 1986, letter sent by the Fed to the GAO about whether the Board is correct in saying that a bank affiliated ETC must derive more than 50 percent of its revenue from exporting with third country trade and countertrade counted as nonexport revenue.

You note that the Fed in its letter cited that it believes that excluding revenues from third country trade would allow and likely result in ETC's owned by banks engaging in activities unrelated to exports.

You then criticize the Fed for offering no evidence to support its opinion.

What evidence does the GAO have or cite that the Fed's worst case outcome is not likely to occur and how do you respond to the Fed's contention that adopting Senator Heinz' proposal on this issue would mean that an export trading company could be a company substantially engaged in third-party trade or countertrade involving two foreign countries with minimal involvement in exporting goods or services from the United States?

Mr. MENDELOWITZ. Senator, the reason why we formulated that presentation was twofold. The Fed in its reply to our report said that it viewed as a likely outcome of the removal of this restriction that a bank ETC would suddenly find itself predominantly involved in nonexporting trade, but it didn't offer us any data or support or evidence to help us understand the basis for this contention.

In the course of our work we did not come across any evidence that would lead us to believe that this is likely.

LACK OF EVIDENCE

Senator PROXMIRE. My question is: What evidence does the GAO have for saying that the Fed's worst case outcome is not likely to occur?

Mr. MENDELOWITZ. It's the absence of any evidence that it would occur that forms the basis of our position.

Senator PROXMIRE. You don't have any evidence that the worst case outcome is not likely to occur, do you?

Mr. MENDELOWITZ. There are two circumstances. They presented no evidence that the worst case would occur and in the course of our data collection on our project—and we talked to a lot of export trading companies and traders and banks, et cetera—that did not arise as a likely outcome.

Senator PROXMIRE. So there is no evidence on either side?

Mr. MENDELOWITZ. I would say that if you look at the 40 bank holding companies that have received authority to invest in export trading companies, there are only 29 that are active. Essentially about a quarter or more aren't active. And from our perspective, based on this kind of evidence that we have uncovered, I would say that rather than engaging in—based on the record of the past several years—rather than suddenly engaging in trade unrelated to U.S. exports and involving themselves entirely with third country trade, et cetera, it's more likely that these export trading companies would just cease to exist rather than go the route suggested by the Board of Governors.

Senator PROXMIRE. On pages 9 and 10 of your testimony you cite five concerns expressed by bank export trading companies about the way the Federal Reserve Board regulates them. One of these concerns was that bank ETC's "must observe the same collateral requirement as nonbank affiliates when borrowing from parent banks."

You say the GAO believes that provision, along with the other four concerns cited, "places bank ETC's at a competitive disadvantage with nonbank ETC's."

Mr. **Mendelowitz**. Correct.

Senator **Proxmire**. Now can you please tell me how requiring a bank ETC to observe the same collateral requirements as a nonbank ETC when borrowing from a parent bank gives the nonbank ETC a competitive advantage?

Mr. **Mendelowitz**. I believe the point that we're trying to make is that there are restrictions that are placed specifically on nonbank affiliates of bank holding companies. The bank ETC has the same type of restrictions as a nonbank affiliate of a bank holding company irrespective of what it's doing. Therefore, a bank export trading company has greater restrictions placed on it than a nonbank ETC.

The lack of equal competitive standing, in essence, is between the bank ETC on the one hand and any other export trading entity that it's competing with on the other.

Senator **Proxmire**. But one of the concerns you state is that the bank ETC's must observe the same collateral requirements as the nonbank affiliates in borrowing from parent banks. I can't for the life of me see why that gives any disadvantage one way or the other. That seems to me the fair way to go. They both are the same.

Mr. **Mendelowitz**. Well, it's nonbank affiliates of a bank holding company. For example, an independent export trading company that would go to a bank to borrow is just an independent company seeking a loan. It can borrow with a secured line of credit; or, it can borrow with an unsecured line of credit and it would be unaffected by that collateral requirement. The only companies that are affected by the collateral requirement are the bank ETC's and other affiliates of the bank holding company.

Senator **Proxmire**. Mr. Luft, in your testimony dealing with the issues of leveraging and section 23A of the Federal Reserve Act, you contrast the Fed's administration of these provisions with the way export trading companies relate to banks in Japan

JAPANESE TRADING COMPANY PRACTICES

Now don't you agree that the practices of the Japanese banks with respect to their trading companies are not a fair comparison? After all, Japanese banks lend in large part according to Government guidelines. The United States has rejected that approach in favor of market rather than governmental allocation of credit in laws designed to ensure that banks remain impartial arbitrators of credit, uninfluenced by ownership ties to borrowers.

Why do you think the Japanese experience with ETC's is relevant to our Federal Reserve Board's concerns about the safety and soundness of U.S. banks?

Mr. **Luft**. Thank you, Senator Proxmire. I think it is relevant because it's not a question of whether or not a comparison is fair, but rather an assessment of what is actually going on in the real world.

The leverage ratio that the Japanese sogo shosha show is a principal factor that has led to their very successful pursuit of international business. There are ways other than the higher leverage ratio of 25 to 1 proposed in the bill to become successful. For example, in Europe you often have the situation of a house bank tie with the export trading company. This means that that bank will have representation on the board of directors of that foreign entity which gives them much closer access to the internal facts and figures of that company and allows the bank then to do the financing that the Japanese sogo shosha would do on its own account. However, this other principal method is also prohibited in the United States because of the operation of commerce and banking.

Senator Proxmire. Mr. Luft, I want to follow up on my question to Mr. Johnson on leveraging. There are thousands of nonbank ETC's leveraged at 2 or 3 to 1. The Heinz bill allows bank ETC's to leverage at 25 to 1. Nonbank ETC's contend that this proposal would so disadvantage them as to drive them out of business.

Do you think that's a valid concern on their part?

Mr. Luft. No, I don't, Senator. First of all, we have to remember that bank-owned ETC's are excluded from two very large ranges of activity—manufacturing and agricultural production—whereas the nonbank ETC's can be involved in those kinds of things. So the realm of competition is, first of all, quite limited.

Second, I think more than putting the nonbank affiliated ETC's out of business, it creates conditions that are favorable for creating partnerships with those other ETC's.

Senator Proxmire. Well, there's a huge difference here. The leverage on one part is 25 to 1 and the leverage on the other is 2 to 1 or 3 to 1 on the average, and the nonbank ETC's certainly don't seem to agree with you because they very much oppose this rule.

Of course, the partnerships would have an adverse effect on their independence, too, and their competitive capacity.

Mr. Luft. I think we do have a difference of opinion that, as you said, some of the existing ETC's feel that they would be at a competitive disadvantage. The other side of the coin is the bank ETC's disagree with this.

I think it's a judgment call more than anything else, but there certainly is no evidence that bank ETC's have been driving nonbank-owned ETC's out of business since this act came into force.

Senator Proxmire. That's why we don't want to change it. The way to maintain a successful relationship is to keep it the way it is.

I would just like to call your attention to an editorial in the September 1980 Wall Street Journal, 6 years ago. It was on a very similar bill by Senator Stevenson and the same argument was made then with respect to the advantage the Japanese have because of their export trading companies. The Journal argued that there's another reason for the success of the Japanese.

It said this:

> The success of Japanese trading companies lies not in their ownership structures or their antitrust freedoms but in their detailed knowledge of production sources and market opportunities around the world as well as their logistical skills in carrying through complicated international transactions. Nothing stops American firms from offering similar services and indeed many already do and there are hundreds of foreign sales agents and manufacturers representatives and so on to serve the export needs of American industrialists

That seems to me to be a far more satisfactory explanation of the Japanese advantage than would be offered here. What's your comment?

Mr. **Luft**. I disagree with that. I think all factors have an effect here. When I was an international commercial banker I dealt with Japanese trading companies located in Europe. Their ability to assume risk was certainly greater than what I saw from their European competitors.

The factors mentioned in that editorial did play a substantial role. I found the level of training in these companies to be quite a bit higher than that inside their competitors that I was dealing with in Europe.

But this is not an issue that I think you can address through legislation. It's more a matter of education and experience in foreign markets.

Senator **Proxmire**. Thank you.

Thank you, Mr Chairman.

Senator **Heinz**. Senator Proxmire, thank you.

EFFECTIVENESS OF THE ANTITRUST PROVISIONS IN THE ACT

I have one last question for you, Mr. Luft. How would you rate the effectiveness of the antitrust provisions in the Export Trading Company Act?

Mr. **Luft**. Well, I would like to make a statement first of all that the administration does not intend at this point in time to introduce any new legislation to make amendments. However, we are considering and reviewing whether or not this is necessary.

Senator **Heinz**. Are there some areas where you think there could be some improvements made?

Mr. **Luft**. This is what is under review on an interagency level at the moment and as soon as we come to an agreed position we would be happy to let the committee know what our decision is.

Senator **Heinz**. So at this point you can't say whether there are or are not particular problems?

Mr. **Luft**. No, I cannot at this time.

Senator **Heinz**. Very well. Gentlemen, I have no further questions for you. I may submit a few additional ones in writing. We thank you both very much for your testimony. We appreciate your coming.

Our next two witnesses are Mr. Malcolm Davies from Manufacturers Hanover World Trade Corp., and Mr. John Lewis of the Rainier International Trading Co. I am advised that Mr. Stephen Sohn of the International Management and Export Development Corp. will not be able to testify today and his testimony is submitted and we will include it in the record.

Mr. Davies.

STATEMENT OF MALCOLM P. DAVIES, PRESIDENT, MANUFACTURERS HANOVER WORLD TRADE CORP., ON BEHALF OF THE BANKERS ASSOCIATION FOR FOREIGN TRADE

Mr. **Davies**. Good morning. Thank you, Mr. Chairman.

Mr. Chairman, members of the subcommittee, my name is Malcolm Davies and I'm pleased to appear before the subcommittee today on behalf of the Bankers Association for Foreign Trade [BAFT], and to express BAFT's strong support for S. 1934. I am a member of BAFT's Export Trading Companies Committee, which has reviewed S. 1934 in great detail. BAFT's committee is composed of representatives from money-center, regional, and international banking organizations. It reflects the spectrum of BAFT's membership.

As the president of Manufacturers Hanover World Trade Corp., I am responsible for the development and line management of our ETC. The company was constituted in its present form 1 year ago approximately.

As you know, BAFT is the trade association of money-center, regional, and smaller banking associations dedicated to the promotion of international trade and finance. It has 128 U.S. voting members and 100 international members from over 30 foreign countries.

Our membership's interest in ETC's is demonstrated by two statistics. Two-thirds of the applications have come from our domestic and international members and, more significantly, of the ETC's currently reported as operating, over three-quarters represent BAFT members.

It has been approximately 3 years since the Federal Reserve issued final regulations implementing the Export Trading Company Act authorizing the investments by bank holding companies in ETC's.

Considering the economic circumstances of the past years, I think you could say the response has been encouraging. That is to say that banks of all sizes and types have responded to the legislative opportunity presented by the act. There is a diversity of investment strategies from de novo to acquisition of existing firms, joint ventures with nonbanking operations and joint ventures within banks.

There is a variety of types of business that these ETC's have undertaken. There is close functioning with the trade financing areas within banks. There is an involvement in the provision of trade services, transportation, insurance, documentation, and other services. There have been consulting, marketing, and distribution activities reflecting particularly the local orientation of the bank and its customer base, and some ETC's have attempted to become the major international operations that perhaps the act envisaged with plugging into the global orientation that their network presents.

RESULTS HAVE BEEN MIXED

However, as good as the response has been from the industry, the results have been mixed, to say the least. The opportunity presented itself to banks at a time of the high value of the dollar which has meant that exporting for all has been difficult. There is, of course, that cliche about the cultural problems of bankers undertaking trade and the absence of experience in this particular field as a result of legislation that took place in this country 50 years ago.

I think there's been a revision of the initial strategies as more experience has been developed. There is no doubt that we are meeting intense international competition in this field and in our opinion the legal and regulatory restraints which, although perhaps well intentioned, have made it difficult for the industry to meet the challenge presented by the act fully.

We feel there is some need to clarify the legal constraints imposed by the act, thus our support for S. 1934.

The export trading company business within banks is at a very early stage of development, notwithstanding the experience of the past years. Fortunately, the economic outlook is becoming more positive and that's encouraging. We have gained experience over the past years and we can put that to good effect I believe.

Unfortunately, we believe that the potential for the banking industry represented by this legislative opportunity is being hindered by uncertainties that exist within the act at the present time and we are, therefore, anxious to see some clarification of the position.

We don't believe that there's a need for a major change in the ETC Act. Rather, we are talking about fine tuning in the light of experience.

We believe that the Federal Reserve Board and its staff have implemented the act in a highly professional manner and, indeed, in the sincere belief that they have been following congressional intent, but there are ambiguities and tensions which we would like to see resolved.

Perhaps I could comment briefly on the need for each of the major provisions included in S. 1934.

To deal first with the question of definition, the fact that such companies must be organized and operated principally for the purposes of exporting goods and services produced in the United States, given the language and legislative history of the act, one cannot fault the Federal Reserve for adopting a regulatory definition that requires more than 50 percent of the ETC's total revenues from exports. The problem is that applying the 50-percent rule against total revenues imposes substantial roadblocks to the growth and profitability of ETC's. It inevitably distorts the pattern of business that an ETC can undertake.

We have to engage in importing and third country trade transactions. We are in a highly competitive environment and the companies that we are competing with have this capability. Without the capability to undertake this nonexport business, we are hindered in our ability to develop this industry in a competitive marketplace.

We, therefore, strongly support title II of S. 1934 which amends the ETC Act to provide that "principally" means an excess of export-related revenues over import revenues. The impact, in other words, on the United States itself.

We support the amendment because it maintains the public policy focus on promoting exports. I think we understand perfectly well our role in that regard. Nevertheless, we do need the flexibility of third-country trade to compete properly in world markets.

Another important change which title II of S. 1934 makes is to the definition of the ETC's to make it clear that they may export goods or services produced in the United States by the company or its affiliates and include income from such activities in its revenues for the purposes of meeting the "principally" test, the 50-percent test.

While we thought that such activities were intended by the ETC Act in 1982, an express legislative clarification would resolve the issue and thus clear up the confusion and disagreement that clearly exists on this matter.

In this connection, we can see no reason why an ETC should be precluded from exporting its own services or those of its affiliates.

The only other comment we would have on the ETC definition is the 2-year timeframe for meeting the test.

Senator HEINZ. Mr. Davies, I'm sorry, your time has expired. You need to keep your testimony to 10 minutes and I think you have run over that.

Mr. DAVIES. I see.

Senator HEINZ. I'm going to have some questions for you, but I'm going to have to call on Mr. Lewis.

Mr. DAVIES. Sure.

[The complete prepared statement follows:]

STATEMENT OF

MALCOLM P. DAVIES, PRESIDENT

MANUFACTURERS HANOVER WORLD TRADE CORPORATION

ON BEHALF OF THE

BANKERS' ASSOCIATION FOR FOREIGN TRADE

ON

S. 1934

THE EXPORT TRADING COMPANY
ACT AMENDMENTS OF 1985

BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL FINANCE
AND MONETARY POLICY
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

JUNE 17, 1986

Mr. Chairman and Members of the Subcommittee:

My name is Malcolm P. Davies and I am pleased to appear before the Subcommittee today on behalf of the Bankers' Association for Foreign Trade ("BAFT"), to express BAFT's strong support for S. 1934, the "Export Trading Company Act Amendments of 1985." I am a member of BAFT's Export Trading Companies Committee, which has reviewed S. 1934 in great detail and which is composed of representatives from money-center, regional and international banking organizations with investments in export trading companies ("ETCs"). I am also President of Manufacturers Hanover World Trade Corporation, a wholly-owned subsidiary of Manufacturers Hanover Corporation of New York.

As you know, BAFT is a trade association of money-center, regional and smaller banking organizations dedicated to promoting international trade and finance. BAFT's 128 U.S. voting members comprise virtually all U.S. banking organizations actively engaged in international banking activities. BAFT also has over 100 international members representing banks from over 30 foreign countries. Our membership's interest in ETCs is demonstrated by the following two facts:

- Of the notifications received by the Federal Reserve Board from bank holding companies to establish ETCs,[1] approximately two-thirds have come from our domestic or international members.
- More significantly, of the ETCs reported by the Federal Reserve to be currently "operating,"[2] almost three-fourths of such ETCs are owned in whole or in part by our domestic or international members.

OVERVIEW OF BANKING ORGANIZATIONS' EXPERIENCE UNDER THE ETC ACT

It has been approximately three years since the Federal Reserve issued final regulations implementing the Export Trading Company Act of 1982 ("ETC Act") authorizing investments by bank holding companies in ETCs. Considering the rather difficult export situation of the past several years, banking organization response to this new opportunity has been encouraging and varied.

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[1] See list of Notifications accompanying Statement by Frederick R. Dahl, Associate Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System before the Subcommittee on Economic Policy & Trade of the Committee on Foreign Affairs, House of Representatives (April 22, 1986).

[2] *Id.*

- Bank holding company investors in ETCs can be found across the United States (see Exhibit A) and across the entire gamut of U.S. banking organizations. They include major money-center and international organizations, leading regional organizations, and smaller, more locally-oriented organizations.
- Banking organizations have embarked on a diversity of investment strategies:
  - -- a number of banking organizations, especially larger organizations, have gone the route of establishing wholly-owned, de novo subsidiaries;
  - -- some banking organizations have acquired existing firms that engage in activities permitted under the ETC Act;
  - -- some banking organizations have formed joint venture ETCs with nonbank firms; and,
  - -- some, mainly smaller, banking organizations have formed joint venture ETCs with other banking organizations.
- Banking organizations have also pursued a variety of business activities and strategies through their ETC affiliates:

- ETCs frequently work closely with an affiliated bank's trade financing group to provide customers with innovative methods of trade finance made possible by the ETC's ability to take title to goods -- this flexibility has made it possible to put together deals that would have been impossible earlier;
- ETCs affiliated with banking organizations often provide "nuts and bolts" trade services to their customers, e.g., transportation, insurance, documentation and other services, that greatly facilitate the export of products by middle-market and smaller companies;
- ETCs affiliated with regional banking organizations often focus on engaging in consulting, marketing, distribution and trading activities in products that reflect their local, regional customer base, e.g., agriculture, high-tech or other specialized product lines;
- some ETCs affiliated with major multinational banking organizations have had a global orientation, pursuing trading opportunities worldwide

through use of their extensive geographic, informational and banking and trade links overseas.

While banking organizations have responded to the opportunities presented by the ETC Act in many different ways, some common problems have emerged over this three-year implementation period.

- Macro-economic conditions of the past few years, particularly the high value of the dollar against foreign currencies (see Exhibit B), the relatively sluggish growth of economic activity in foreign industrial countries and the drop in imports of countries experiencing debt-burden difficulties, made it extremely difficult to start export-oriented activities during this period.
- The absence of commercial trading experience in banking organizations has caused them to evaluate very carefully the opportunities presented by ETCs and to proceed in a very deliberate manner in terms of making investments and engaging in new activities.
- ETCs affiliated with banking organizations have, in some cases, had to revise initial strategies and business development objectives as more experience was developed.

- International competition in this area is intense, especially from well-established European, Japanese and Asian trading companies, which often can quote razor-thin profit margins due to significant economies of scale developed over many years.
- Certain statutory and regulatory constraints have made it difficult, in many cases, for ETCs affiliated with banking organizations to grow and compete effectively in the international marketplace.

THE NEED TO CLARIFY AND, IN SOME CASES, MODIFY THE LEGAL CONSTRAINTS IMPOSED ON ETCs AFFILIATED WITH BANKING ORGANIZATIONS

It is not surprising, given the substantial economic and competitive obstacles cited above and the normal difficulty in establishing a new business, that the export trading company industry is still at a very early stage of development. Fortunately, the economic outlook is becoming more positive, especially in view of the recent drop in U.S. dollar exchange rates. In addition, ETCs have gained valuable business experience over the past few years and as successful ETC models emerge, more and more banking organizations are likely to show interest in ETC investments as a way of diversifying their activities, of promoting exports and trade finance and of strengthening and developing customer relationships. Unfortunately, this potential will not be realized unless Congress is willing to review the ETC Act and either clarify or modify certain legal authorities or constraints that are contained therein and which impair the development of competitive and profitable ETCs.

BAFT does not believe that there is a need for major changes in the ETC Act. Rather, we are at a stage now where some important fine-tuning is needed in light of experience. S. 1934 clearly follows this approach, as the modifications or clarifications contained therein are carefully focussed on very real impediments to ETC operations. In this connection, we believe the Federal Reserve Board and its staff have implemented the ETC Act in a highly professional manner and in a sincere belief that they have been following Congressional intent. Admittedly, there are ambiguities in the statute and its legislative history and there is continual tension throughout the ETC Act between promoting exports and more traditional policies separating banking and commerce. The changes proposed by S. 1934 are needed because they will resolve the most important of these ambiguities or tensions in a manner that will help ETCs realize their potential without undermining fundamental principles of bank safety and soundness. In this connection, we would like to comment briefly on the need for each of the major provisions included in S. 1934.

DEFINITION OF EXPORT TRADING COMPANY

Under existing law, to be eligible for investment by a bank holding company, an ETC must be "organized and operated principally for purposes of exporting goods or services produced in the United States." To meet this "principally engaged" test under Federal Reserve regulations, an ETC must derive more than one-half of its revenues in each consecutive two-year period from the export of, or from facilitating the export of, goods or services produced in the United States. (12 C.F.R. 211.32(a)).

Given the language and legislative history of the ETC Act, one cannot fault the Federal Reserve for adopting a regulatory definition which requires that more than 50 percent of an ETC's total revenues must come from exports. The problem is that applying this "more than 50 percent" rule against total revenues imposes very substantial roadblocks to the growth and profitability of ETCs. As recognized by Congress when it enacted the ETC Act in 1982, to be viable business entities in the highly cyclical world of international trade, ETCs have to engage in importing and third country trade transactions. Without such capability, ETCs cannot develop the business relationships or volume to compete internationally. Unfortunately, the "principally engaged" requirement as now construed and applied creates a significant impediment to the development of third-country trade transactions, because such transactions are, in effect, considered import transactions and thus weighed against export transactions under the formula. The requirement thus frustrates the development of a broader and more profitable business base and inhibits the development of countertrade transactions which, at times, may be crucial to a U.S. export sale, e.g., situations where to make an export sale, foreign goods must be taken in payment and sold abroad.

BAFT thus strongly supports section 2 of S. 1934 which amends the ETC Act to provide that "principally" means an excess of export-related revenues over import revenues, thereby excluding third country transaction revenues from the test entirely. Since the ETC definition is the cornerstone of the ETC Act, we believe it important that Congress establish a clear legislative standard. Substantively, we support the amendment because it maintains the public policy focus on promoting exports over imports, but nevertheless gives ETCs affiliated with banking organizations the flexibility to engage in third-country trade transactions which have no impact on the U.S. trade balance.

The other important change which Section 2 of S. 1934 makes to the definition of an ETC is to make it clear that an ETC may export goods or services produced in the United States "by the company" or "its affiliates" and include income from such activities in its revenues for purposes of meeting the "principally" test. While we thought such activities were intended by the ETC Act in 1982, the statutory language is not clear and thus we would welcome a statutory clarification on this point. In this connection, we can see no reason why an ETC should be precluded from exporting its own services or those of its affiliates, especially since service exports are the brightest spot in our trade picture.

The only other comment we would have on the ETC definition is that the two-year time period for measuring revenues under current regulations can present special problems for de novo ETCs, which need to build their distribution capability in global markets and at the same time generate revenues to cover high start-up costs. We would thus hope that both Congress and the Federal Reserve would be willing to follow a flexible approach toward time periods for measuring revenues, especially for start-up operations.

APPLICATION OF SECTION 23A

The virtually simultaneous consideration by Congress of the ETC Act and the Banking Affiliates Act in 1982 led to the somewhat anomalous situation whereby ETCs affiliated with banks were exempted from the "old" but not the "new" section 23A of the Federal Reserve Act, which section imposes amount limitations and collateral requirements on extensions of credit from a bank to an affiliated ETC and other affiliates.

The reasons which led Congress in 1982 to exempt ETCs from the collateral requirements of the "old" § 23A apply equally to the "new" § 23A and thus we support Section 3 of S. 1934, which would exempt bank transactions with an ETC affiliate from the "new" Section 23A adopted in 1982 in the Banking Affiliates Act. Foreign trading companies are almost invariably linked to a banking organization, which provides them with valuable credit resources. To be competitive internationally and to reap one of the chief benefits of bank affiliation, ETCs need access to credit from affiliate banks without having to comply with onerous collateral requirements, which are virtually impossible for most ETCs to meet given the nature of their operations, or to compete with other bank affiliates for the limited pool of credit available under the aggregate limits of § 23A. In this connection, to meet safety and soundness concerns, the ETC Act already includes (i) stringent amount limitations on extensions of credit from banking organizations to ETC affiliates and (ii) strict prohibitions against any preferential lending by a bank to its ETC affiliates.

LEVERAGING RATIO AND INVENTORY LIMITS

Sections 4 and 5 of S. 1934 concern two issues which were not specifically addressed in the ETC Act, but which are included in present Federal Reserve regulations -- leveraging and inventory limitations. In an effort to speed the processing of bank holding company notifications to invest in ETCs, the Federal Reserve has delegated authority to the twelve Federal Reserve Banks to process ETC investment notifications, subject, however, to certain conditions. One condition provides that an ETC's leveraging ratio cannot exceed 10 to 1; another condition specifies that an ETC cannot propose to maintain inventory of more than $2 million. See 12 C.F.R. § 265.2(f)(46). Any notification failing to meet either condition has to be processed in Washington. Essentially, as a general policy matter, the Federal Reserve has indicated to banking organizations proposing investments in ETCs that leverage ratios up to 10 to 1 and an inventory of goods up to $2 million present no regulatory problems; however, any proposals exceeding those limits present policy issues which have to be carefully reviewed in Washington.

While we commend the Federal Reserve for its willingness to delegate processing of notifications to the Federal Reserve Banks, we believe its general policies regarding leveraging and inventory limitations are, perhaps unintentionally, having a chilling effect on ETC operations and serve as real practical business impediments to the growth and profitability of ETCs. We support sections 4 and 5 of S. 1934 because we believe it important that Congress establish clear legislative policies in these two crucial operational areas.

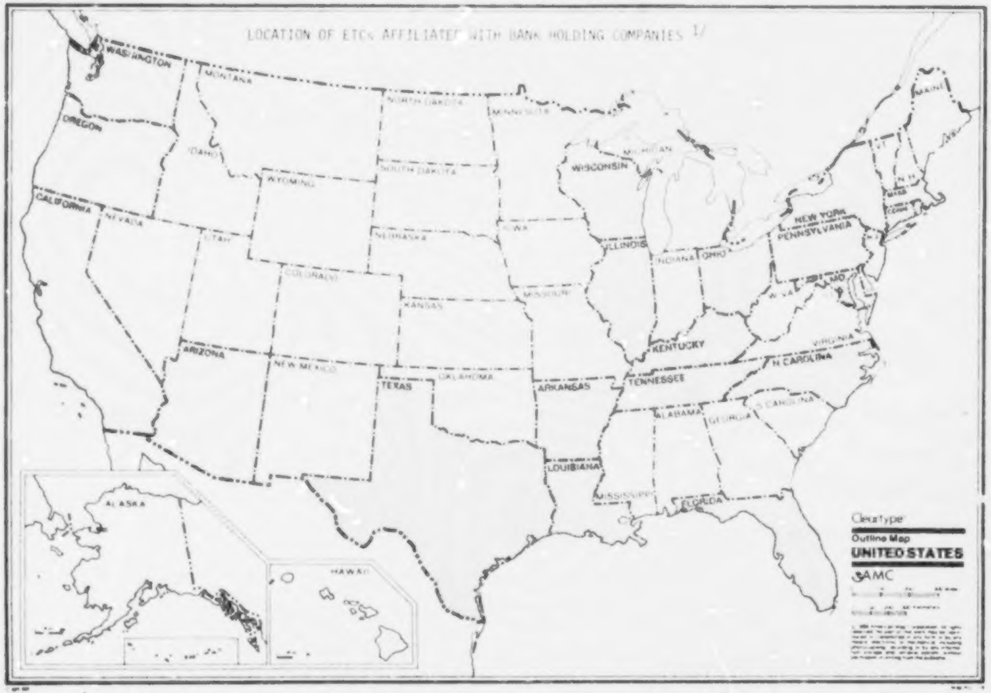
The problem presented by general regulatory limitations on leverage and inventory is that bank-affiliated ETCs are, as previously described, structured in many diverse ways, including as joint ventures with nonbanks, and are engaged in many diverse activities. General rules in these areas are thus, perforce, highly arbitrary: what is needed is a highly flexible, case-by-case approach to these issues that recognizes the realities of international competition. For example, an ETC providing only export services will not be affected by an inventory limit: however, an ETC planning to engage in the trading of goods can find its operations severely hampered by inventory limitations, which it may have to constantly seek regulatory waivers for as its business grows. The problem is that continued trips to the regulator for waivers takes valuable time that can result in lost business opportunities.

The approach taken by sections 4 and 5 of S. 1934 is, we believe, sound from both a regulatory and business standpoint. The Federal Reserve retains ample authority to consider leveraging and inventory controls on a case-by-case basis; by the same token, ETCs are given much more freedom to propose leveraging ratios and inventory operations that will allow them to be more competitive. In this connection, with respect to leverage, foreign trading companies often have leverage ratios in excess of 20 to 1. If an ETC's operations and controls are sound, it should be permitted to have a relatively high leverage ratio in order to be competitive. S. 1934 would allow this, by establishing that a 25 to 1 leverage ratio is not a *per se* grounds for denying a notification. Nevertheless, S. 1934 would allow the Federal Reserve to deny a notification with a leverage ratio less than 25 to 1, if other factors indicated that the ETC would not be well-managed with respect to the possible risk of its operations and would pose risks to its affiliate bank.

CONCLUSION

In conclusion, I would like to express BAFT's appreciation for this opportunity to present our views in support of S. 1934.

EXHIBIT A



LOCATION OF ETCs AFFILIATED WITH BANK HOLDING COMPANIES 1/

WASHINGTON
MONTANA
NORTH DAKOTA
MINNESOTA
MAINE
OREGON
IDAHO
SOUTH DAKOTA
WISCONSIN
MICHIGAN
VT
N.H.
MASS
CONN
WYOMING
CALIFORNIA
NEVADA
UTAH
NEBRASKA
IOWA
ILLINOIS
INDIANA
OHIO
NEW YORK
PENNSYLVANIA
COLORADO
KANSAS
MISSOURI
W. VA
MD
KENTUCKY
VIRGINIA
ARIZONA
NEW MEXICO
OKLAHOMA
TEXAS
ARKANSAS
TENNESSEE
N CAROLINA
ALABAMA
GEORGIA
S CAROLINA
LOUISIANA
MISSISSIPPI
FLORIDA
ALASKA
HAWAII
Cleartype
Outline Map
UNITED STATES
AMC

1/ Includes all ETCs for which notifications have been filed with the Federal Reserve Board

Source: Federal Reserve Board

Senator HEINZ. John Lewis.

STATEMENT OF JOHN LEWIS, VICE PRESIDENT AND MANAGER, RAINIER INTERNATIONAL TRADING CO.

Mr. LEWIS. Thank you, Mr. Chairman. I have submitted written testimony and I would appreciate having that included in the record. I shall summarize briefly.

Senator HEINZ. Without objection, so ordered.

Mr. LEWIS. Thank you.

My name is John Lewis, vice president and manager of Rainier International Trading Co. which is the export trading company subsidiary of Rainier Bancorp., headquartered in Seattle, WA.

It's a pleasure to be here today and I would like to comment briefly on the interest of our institution and our region in export trade.

Rainier Bank is unusual among regional banks in having a large proportion of its activities concerned with international trade and international banking, with roughly 20 percent of its assets in the international area. We have 20 international offices. Rainier ranks fourth among U.S. commercial banks in Asia.

The Pacific Northwest in many respects leads the United States in export performance. For example, Washington State exports a higher percentage of its total gross product than any other State; in fact, that percentage is roughly twice the percentage of the United States GNP which is exported in international trade. We rank first per capita among all States in exports. Roughly 20 percent of the jobs in Washington State depend on international trade; in fact, one out of every three farming jobs in the State depends on exports.

We certainly support the position of the Bankers Association on Foreign Trade as presented by Mr. Davies. We are a member of that organization. There are two of the specific provisions addressed by BAFT which our experience in managing an export trading company has shown to be particularly relevant: First, the third country trade provision; and second, the export of services provision.

ETC'S IMPROVE ABILITY TO COMPETE

Briefly, the availability of export trading company services improves the ability of U.S. banks to compete for certain kinds of trade finance, particularly that between foreign countries. This is an area of growing importance for U.S. banks, whose export of the vitally important service—that is, banking—from the United States is assisting in the financing of trade between foreign countries. The ability of bank export trading company services to be added to the mix of services offered by U.S. banks will make us more competitive with the Asian and European banks with which we already compete.

Countertrade, whether or not one views it as a distortion of free and fair trade, is a fact of life. According to some reports countertrade is increasing in dealing with countries such as China; because exclusion of third country trade from the definition of imports under the ETC Act will allow bank ETC's greater freedom to consider assisting United States exporters in these types of transactions it should assist United States export competitiveness. The fundamental objective is, of course, to foster the export of U.S. goods.

On a related point also covered under section II, the export of services should not be discouraged, as it is under the present interpretation of the ETC regulations. Because of the increasingly complex nature of international trade and the need to approach foreign markets with knowledge and sophistication, the use of a variety of services to aid exporters has long been common. These services include export management, market research, et cetera.

Not only is it important to encourage U.S. competitiveness in export of services as well as in products, but most importantly the availability of these services from a U.S. entity such as a bank to a U.S. product exporter may increase the exporter's willingness to use those services and improve his eventual chances of success.

An example of this was a recent statement by a Northwest forest products firm which has been competitive in the highly difficult Japanese market. The president of this firm stated that closed markets and unlevel playing fields, although they have been problems, are not the only problems in exporting and should not be used as scapegoats. In fact, a concerted effort to learn and understand the Japanese market and the Japanese distribution channels, et cetera, was essential in his success.

U.S. firms do need assistance in exporting and in many cases are willing to request this assistance in order to do a better job of marketing overseas.

I would like to make an important point that this type of export assistance has to some extent been provided by the International Trade Administration [ITA] of the U.S. Foreign and Commercial Service. However, the budget of the International Trade Administration has recently been drastically cut. Currently for example, the Western region of the ITA is operating at only 31 percent of its original budget, a cut of almost 70 percent.

The crucial issue here is that if these vitally important types of services are expected to be provided by the private sector instead of the ITA, under these budget cuts, then regulations which restrict U.S. banks; which are already among our strongest international competitors; from providing these services are not in this country's best interest

BANK AND NONBANK ETC'S WORKING TOGETHER

In response to Senator Proxmire's comments on competitiveness between bank ETC's and nonbank ETC's, a model which is evolving—I know of at least one west coast and one east coast ETC which are using this model—is a collaboration between bank ETC's and nonbank ETC's in which the marketing skills of the nonbank ETC are combined with the financial strength and the business resources of the bank ETC to allow them to consummate transactions jointly which would not have been possible for either alone. Thus, I believe that a positive relationship rather than a negative adversarial one is developing between bank and nonbank ETC's.

In summary, U.S. banks have responded positively to the message received from Congress in the 1982 act that they should use the ETC Act to provide additional assistance to U.S. exporters. That is, that banks should themselves become actively involved in fostering the improvement of the U.S. balance of trade.

A variety of approaches have been tried and considerable effort and money invested, both because of the business potential and because of the desire to be responsive to the trade situation. Not all bank ETC's have been unsuccessful. There are several patterns of successful ETC activity emerging.

In conclusion, Rainier supports S. 1934 as a set of refinements to the Export Trading Company Act based upon the lessons of experience. The demonstration by Congress that it is responsive to reasonable requests from institutions in the trenches of exporting will reinforce the willingness of U.S. banks to continue to exert not only their financial resources but their considerable ingenuity and energy toward improving U.S. export competitiveness.

Thank you.

[The complete prepared statement follows:]

Statement on S.1934 by
John Lewis
Vice President and Manager, Rainier International Trading Company
before the
Subcommittee on International Finance and Monetory Policy
of the
Committee on Banking, Housing and Urban Affairs
United States Senate

June 17, 1986

Mr. Chairman and Members of the Subcommittee:

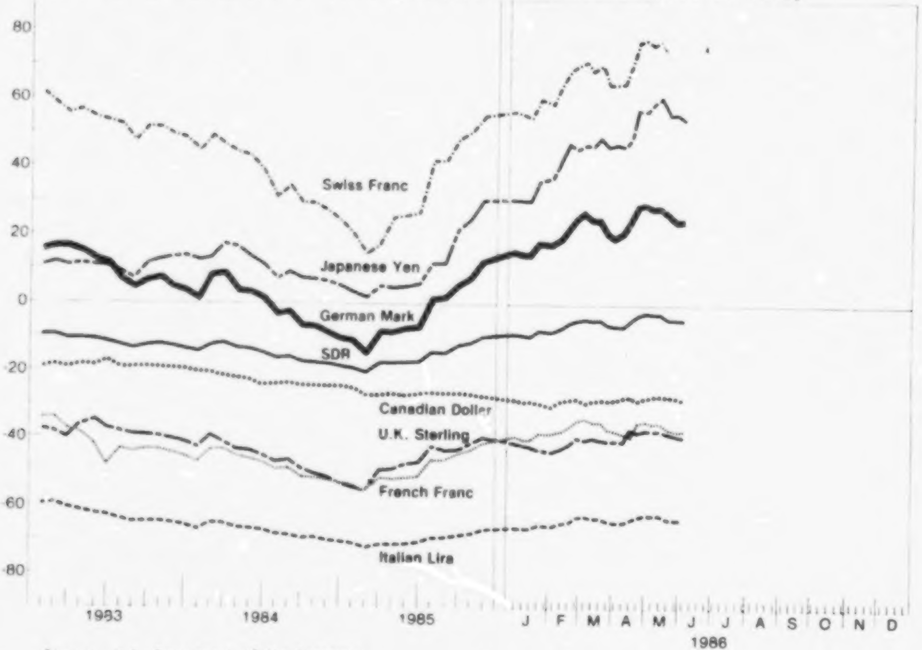
My name is John Lewis, Vice President and Manager of Rainier International Trading Company. It is a welcome opportunity to appear before the Subcommittee today on behalf of Rainier Bancorporation to express our strong support for S.1934, the "Export Trading Company Act Amendments of 1985." Rainier Bancorporation is a bank holding company headquartered in Seattle, Washington. Rainier's subsidiaries include Rainier National Bank, the largest independent bank in the Pacific Northwest with over 8 billion dollars in assets, and Rainier Financial Services, providing mortgage and leasing financing throughout 10 Western States. As an international bank, Rainier is much more active than most regional banks. Our network of 20 international offices in eight countries around the Pacific rim represents approximately 20% of the company's total assets. In fact, Rainier ranks fourth among U.S. banks in Asia.

The Pacific Northwest, and particularly the State of Washington, leads the United States in many measures of export performance. For example:

- Washington State ranks first in per capita exports among all states, according to a recent Department of Commerce study.
- Washington exports a higher percent of its total gross product than any other state.
- One out of every eight jobs in King County which includes Seattle, is related to harbor or airport activity.
- The Department of Commerce estimates that one out of every three farming jobs in Washington depends on exports.
- In total, 20% of the jobs in Washington State depend on international trade.
- Washington State's international trade as a percentage of its Gross Product is twice the percentage of the U.S GNP in international trade.

EXHIBIT B

Percentage Increase (or Decrease) in the Value of Major Foreign Currencies and the SDR in Terms of the Dollar (above or below Cost as of March 1973)



Source: U.S. Department of the Treasury

Rainier Bank supports the position of the Bankers' Association on Foreign Trade, BAFT, presented here today by Mr. Davies. In particular, Rainier's experience with its export trading company has demonstrated the importance of two proposed amendments to the 1982 ETC Act: those relating to third-country trade and to the export of services.

Third-country trade, in which trade occurs between two countries other than the U.S., is an important source of business and area of opportunity for U.S. banks, especially in the Pacific Rim. In that availability of ETC services improves the ability of U.S. banks to compete for trade finance and other business with foreign banks, this improves the competitiveness of U.S. banks - major exporter of services.

Some reports indicate that the willingness and ability to employ countertrade are increasingly important in obtaining export sales to a number of countries, including China. Whether or not one views countertrade as an undesireable distortion of free and fair international trade, it is nevertheless a fact of life today. Because exclusion of third-country trade from the definition of imports under the ETC Act will allow bank ETC's greater freedom to consider assisting U.S. exporters in these types of transactions, U.S. export competitiveness should improve.

On a related point, also covered under Section 2 of S.1934, the export of services by bank ETC's should not be discouraged (as it is under the present interpretation of the requirements). Because of the increasingly complex nature of international trade and the need to approach foreign markets with knowledge and sophistication if appreciable market share is to obtained, the use of a variety of services to aid exporters has long been common. These services include export management, market research, distribution management, and services related to the formation of joint ventures. It is important to encourage U.S. competitiveness in export services as well as products, and the availability of these services from a U.S. entity to a U.S. product exporter may make the difference in the exporter's success.

As stated recently by the head of a Northwest forest products firm which has been successful in the highly competitive Japanese market, it is wrong and potentially harmful to treat "closed markets" or "unlevel playing fields" as scapegoats for U.S. exporters. This firm was able to achieve success only after appreciable time, effort, and money had been expended on learning the characteristics of the Japanese market and distribution system and developing relationships with Japanese importers. Similar evidence is ample: more U.S. firms simply must do a better job of marketing overseas. However, despite this need, and despite the stated goal of the Administration of improving U.S. exports, the budget of the International Trade Administraiton has been drastically cut. The ITA provides valuable market research and other services to U.S. exporters and conducts training courses on exporting throughout the U.S.; currently the Western region is operating at only 31% of its original budget - a cut of almost 70%. If these vitally important services are to be provided by the private sector instead, then regulations which restrict the ability of U.S. banks (already among our strongest international competitors) to provide them are not in this country's best interests.

Staff at the EXIM Bank report that, for small-to-medium-sized U.S. exporters, it is more of a problem to develop appropriate export management and marketing capabilities than to obtain competitive export financing terms.

As examples of the usefulness of the ETC Act to banks in promoting exports, two types of transactions may be illustrative. First, there are numerous small trading companies in the U.S., often not connected with a manufacturer or producer of goods. Many of these small firms are quite knowledgeable in certain product or geographic areas, and very industrious in developing potential export transactions, but lack the financial strength to acquire the U.S. goods and complete the sale. Several U.S. bank ETC's have had success working with such small trading companies, combining their financial strength and expertise with the specialized skills of the traders. This type of relationship certainly is consistent with the original intent of Congress in passing the ETC Act.

As a second example of successful ETC relationships, some larger exporters have occasional need to work through an independent third party to complete their transactions, for reasons of confidentiality among others. Bank ETC's can provide the needed assistance as part of a comprehensive trade finance service, again causing export trading transactions to take place which otherwise would have been infeasible.

U.S. Banks responded positively to the message received from Congress that they should use the ETC Act to proved additional sssistance to U.S. exporters. In fact, a variety of approaches have been tried, and considerable effort and money invested, both because of the business potential and because of the desire to be responsive to the trade situation.

Not all bank ETC's have been unsuccessful. There are several patterns of successful ETC activity emerging after the learning and testing experiences of the past few years. It is far too soon to determine whether any sizable number of U.S. banks will be able to realize the intended benefits of this Act.

In summary, Rainier supports S.1934 as a set of refinements to the ETC Act based upon the lessons of experience. The demonstration by Congress that it is responsive to reasonable requests from institutions "in the trenches" of exporting will reinforce the willingness of U.S. banks to continue to exert not only their financial resources but their considerable ingenuity and energy towards improving U.S. export competitiveness.

Senator HEINZ. Mr. Lewis, thank you very much.

Let me recognize Senator Hecht if he has any opening statement he wishes to give.

Senator HECHT. No. Thank you very much, Mr. Chairman.

Senator HEINZ. Senator, thank you.

CONCERN OF FED POLICY WITH ETC'S

Well, Mr. Davies, let me ask you this. Governor Johnson indicated in his testimony that the Federal Reserve Board has received few, if any, complaints about its application and its administration of the Export Trading Company Act.

For the record, have your member banks of BAFT raised issues with the Fed and in what areas have you raised them and to what extent have you been dissatisfied?

Mr. DAVIES. Well, I think one member bank was the bank that applied for an increased leveraging ratio up to 17 to 1 but I think generally speaking the membership is cautious in a new activity and is not anxious indeed to challenge the Fed's position at this point in time.

They are gaining experience and gaining confidence perhaps. So at this point I don't think there has been any serious attempt to amend the established pattern as represented by the delegated authority given to the State Federal Reserve Boards.

Senator HEINZ. Mr. Lewis, has your bank raised any specific issues with the Fed or any specific concerns?

Mr. LEWIS. No, sir; we have not.

Senator HEINZ. If we were to bring the Federal Reserve Board people back in here, would you, on behalf of your bank, raise any specific concerns?

Mr. LEWIS. Yes; as I pointed out in my testimony, the third country trade and particularly the export of services issue, there appears to be some confusion. I was pleased to hear that——

Senator HEINZ. Now we're talking about their administration of the act.

Mr. LEWIS. That's right.

Senator HEINZ. There are some areas where they may be in fact interpreting the statute correctly in which case your complaint would be with the statute rather than with the Fed.

In both those instances, though, you believe it is the Fed's interpretation?

Mr. LEWIS. That's right, it is their interpretation.

Senator HEINZ. Very well. Why didn't you take this up with the Fed or your bank take this up with the Fed at some earlier time?

Mr. LEWIS. Well, let's see. I suppose the reason would be that we have not yet progressed to the point that those have become major limitations for us, although we do foresee their becoming limitations in the near future.

Senator HEINZ. Would you say that again?

Mr. LEWIS. We have not yet progressed to the point where they have become major limitations for us at the present, but we do foresee their becoming limitations for us in the near future.

Senator HEINZ. I see. Now, one of the points raised by Senator Proxmire was quite interesting, and maybe you could respond to this. In discussing the loan and capital limitations, the 10 and 5 percent of capital and surplus limitations, on bank affiliated export trading companies, Senator Proxmire said,

> Well, in theory, if the Congress said that an application couldn't be disapproved solely because there was a ratio that was lower than 25 to 1, wouldn't that allow a bank to form an export trading company, let's say lend it 10 percent of its capital, and hypothetically leverage that 24 to 1, for example to 999 to 1 and get itself exposed to the tune of nearly 250 percent of its capital?

What do you say to that kind of argument?

Mr. LEWIS. My response would be that a provision of the original act which is not addressed in this amendment should clearly cover that, and that is the provision that a bank may not lend to its ETC under more favorable terms than it would lend to any other entity. It seems to me that covers the danger.

Senator HEINZ. So that would prevent that kind of preference from being extended in a way that would jeopardize any more than any other kind of bank loan to a nonaffiliate?

Mr. LEWIS. Yes, sir, in my opinion.

BANKS INVOLVEMENT OF EXPORT SERVICES

Senator HEINZ. Now the other issue that was brought up was that apparently there are people who export services who don't like the provision that would allow, under this legislation, bank affiliated export trading companies to export services that are not their services.

Is it unfair to allow banks to export these services that are produced by others in competition with whoever else is in a position to export those services? Is that a legitimate concern? If not, why not?

Mr. DAVIES. I don't believe it is a legitimate concern. I don't see that the bank ETC's providing services offer any threat to existing organizations be they in the service side of exporting or otherwise.

I think what we are seeing, as Mr. Lewis referred to, is a growing alliance between perhaps the financial muscle of the banks and the small companies that provided traditional services to the exporting community in the United States.

I think, if I may make a point, referring to some of the other points that Senator Proxmire made, the problem has been that these small companies are undercapitalized and have been relatively unsuccessful for that reason. I would have thought and hoped that the bank ETC's with their financial muscle power would be able to redress the problem.

In a sense you could say that the nonbank ETC's have failed substantially and that is the point of bringing people with financial power and with an international network into the arena. And I see the alliance as between people with that muscle power and the people perhaps with more traditional expertise in the field—I see that alliance as a very potent one.

Senator HEINZ. Are foreign banks by and large prohibited from exporting to other countries other than the United States the kind of services that bank affiliated export trading companies might want to export?

Mr. DAVIES. Not that I'm aware. They are not so hampered.

Senator **Heinz**. Governor Johnson seemed a little unsure as to the extent to which what I described as merchant banking was the rule rather than the exception. Is merchant banking the rule rather than the exception in the rest of the market economy world?

Mr. **Davies**. I can't be sure of that frankly, but I would say that there are not the restrictions on banks in other countries. Whether or not banks in other countries are actively involved in trading activities—and I would distinguish that from merchant banking activities—but trading activities, I would say it varies.

Senator **Heinz**. We're talking services at this point.

Mr. **Davies**. The provision of nonbank-type services?

Senator **Heinz**. Yes.

Mr. **Davies**. I would say, generally speaking, they are not hindered in the way that American banks are.

Senator **Heinz**. They may or may not do it, but they are not prevented from doing it?

Mr. **Davies**. That's right.

FLEXIBLE TREATMENT ON LEVERAGING AND APPLICATION OF SECTION 23A

Senator **Heinz**. Now both of you indicate that more flexible treatment on leveraging export of services and application of section 23A is needed because of the wide variety of export trading companies that have been tried.

Is your bank's ability, either as a group or singly, to experiment with this new type of incentive severely limited by these rules? Are these areas which you shy away from because of these rules?

Mr. **Davies**. Speaking for Manufacturers Hanover, it is not hindered at all by section 23A considerations, but the membership of BAFT could very well experience difficulty—covering as it does a wide range of different types of banking institutions, there could very well be a hindering effect.

Senator **Heinz**. Mr. Lewis.

Mr. **Lewis**. We have not been hindered by section 23A but we have been by the export of services and the third country provisions.

At an export trading company conference in New York in October of last year organized by the Department of Commerce, there were several bank export trading companies which specifically mentioned that they had been hindered by section 23A and by the capital ratio requirements.

Senator **Heinz**. I'm sorry, Mr. Lewis. Could you repeat the last part of that?

Mr. **Lewis**. At a bank export trading company conference last October in New York City organized by the Department of Commerce, several bank ETC's did comment that they had been hindered by section 23A and by the ratio requirements.

Senator **Heinz**. All right. Well, thank you.

Well, gentlemen, do you have any other comments you would like to make on any of the testimony you heard today from Governor Johnson or anybody else?

Mr. **Davies**. No; I don't think so.

Senator HEINZ. Mr. Lewis.

Mr. LEWIS. I was pleased to hear that the Fed does allow the export of some type of services, but I believe that there is a lack of clarity on that among bank ETC's and perhaps this bill would help to clarify the situation and reduce uncertainty.

Senator HEINZ. In terms of priority in the legislation that's before us, thinking of section 23A, the change in the leveraging guidance to the Fed, and with respect to the export of services produced by others, how would you rank those in terms of greatest priority recognizing that they are all important to you?

Mr. Davies, would you prioritize those in some way or not?

Mr. DAVIES. Well, I think the two things which are very important is the revenue test and the timeframe at which we are required as an industry to meet that test, recognizing that we're in a startup situation in this business.

For the rest, section 23A and the leverage—well, I think section 23A would come second in terms of importance.

Leveraging I would say must vary very much between individual banks and perhaps I would put that at the third level of priority.

Senator HEINZ. Very well.

Mr. LEWIS. Yes. I've spoken recently with the heads of two other west coast bank ETC's and there is unanimity among us that the definition of exports—including the export of services—and the capital ratio requirements are the most important factors of this bill.

Senator HEINZ. Very well. Well, gentlemen, thank you very much for your testimony. We greatly appreciate your assistance to all of us. Thank you.

The hearing is adjourned.

[Whereupon, at 11:25 a.m., the hearing was adjourned.]

[The complete prepared statement of Mr. Stephen Sohn follows:]

EXPORT TRADING COMPANIES

BY

STEPHEN SOHN
PRESIDENT
IMED
INTERNATIONAL MANAGEMENT AND EXPORT DEVELOPMENT CORP.

BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL FINANCE
AND MONETARY POLICY
OF THE
SENATE COMMITTEE ON BANKING,
HOUSING, AND URBAN AFFAIRS
WASHINGTON, D.C.

JUNE 17, 1986

BEST COPY AVAILABLE

I AM STEPHEN SOHN, PRESIDENT OF INTERNATIONAL MANAGEMENT AND EXPORT DEVELOPMENT CORPORATION (IMED), A CONSULTING-BUSINESS ADVISORY ORGANIZATION SPECIALIZING IN INTERNATIONAL TRADE AND FINANCE. ONE OF OUR AREAS OF FOCUS IS COUNTERTRADE AND OFFSETS IN WHICH WE ADVISE OUR CLIENT ON THE BEST STRUCTURE, APPROPRIATE TRADING VEHICLE TO UTILIZE, ASSIST IN NEGOTIATING CONTRACTS AND CONSUMMATING THE TRANSACTION.

I AM PLEASED TO TO BE INVITED TO COMMENT ON **EXPORT TRADING COMPANIES, A SUBJECT THAT IS SO VERY CRITICAL TO AMERICA'S EXPORT PERFORMANCE.**

BACKGROUND

WHEN THE EXPORT TRADING COMPANY ACT WAS SIGNED INTO LAW IT WAS HAILED BY BOTH CONGRESS AND PRESIDENT REAGAN AS A MAJOR STEP FORWARD IN INCREASING OUR EXPORT COMPETITIVENESS. SUPPORTERS HOPED EXPORT TRADING COMPANIES WOULD DRAMATICALLY INCREASE EXPORT OPPORTUNITIES FOR SMALL AND MEDIUM-SIZED EXPORTERS -- SECRETARY BALDRIDGE PREDICTED MORE THAN 300,000 TRADE RELATED JOBS WOULD BE CREATED BY 1985. THE FORECASTED TRADE REVOLUTION HAS BEEN A DISAPPOINTMENT, TO SAY THE LEAST.

AS YOU ARE AWARE, MR. CHAIRMAN, MY INVOLVEMENT IN THE EXPORT TRADING COMPANY LEGISLATION BEGAN IN 1978 WHEN BOTH YOU AND SENATOR ADLAI STEVENSON BEGAN TO FOCUS ON THIS OPPORTUNITY DURING THE HEARINGS ON U.S. EXPORT POLICY HELD IN EARLY 1978 BY THIS SUBCOMMITTEE. THE SUBCOMMITTEE REPORT, ISSUED IN

MARCH 1979, INCLUDED A RECOMMENDATION THAT U.S. EXPORT TRADING COMPANIES BE ESTABLISHED TO EXPAND EXPORTS OF THE PRODUCTS OF SMALLER U.S. PRODUCERS.

S1663 THE EXPORT TRADING COMPANY ACT OF 1979 WAS INTRODUCED ON AUGUST 2, 1979, REVISED AS S2379 AND AGAIN AS S2718 AS THE EXPORT TRADING COMPANY ACT OF 1980 AND FINALLY REINTRODUCED IN 1982 AS THE EXPORT TRADING COMPANY ACT OF 1982 AND PASSED ON OCTOBER 8, 1982 - CONSISTENTLY SPONSORED BY YOU MR. CHAIRMAN.

YOUR **PERSEVERANCE, DEDICATION AND FIRM COMMITMENT** DURING THESE PAST EIGHT YEARS IS EVIDENCED AGAIN BY THESE HEARINGS TODAY. IN BEHALF OF THE AMERICAN EXPORTING COMMUNITY AND FUTURE EXPORTERS - **THANK YOU.**

MY OWN COMMITMENT TO THE EXPORT TRADING COMPANY (E.T.C.) CONCEPT IS EXEMPLIFIED NOT ONLY IN MY PRESENT CAPACITY BUT, I LEFT UNITED TECHNOLOGIES IN 1984 TO ESTABLISH AN EXPORT TRADING COMPANY AT BANKERS TRUST COMPANY, THE EIGHTH LARGEST BANK IN THE UNITED STATES. AS PRESIDENT AND CHIEF OPERATING OFFICER OF BANKERS TRUST INTERNATIONAL TRADING COMPANY, I ATTEMPTED TO ACCOMPLISH AS MANY OF OUR LONG ESTABLISHED GOALS AS POSSIBLE.

ETC REALITIES

SEVERAL FACTORS BEYOND ONE'S CONTROL WORKED AGAINST ME AND THE TRADING COMPANY - MOST OF WHICH ARE GENERALLY KNOWN AND ONE KEY FACTOR WHICH IS LESS DISCUSSED:

- THE **VALUE OF THE DOLLAR** VS. COMPETITORS' CURRENCIES.

- THE LEVEL AND GROWTH OF **GROSS NATIONAL PRODUCT (GNP)** IN FOREIGN COUNTRIES.
- THE AVAILABILITY OF INTERNATIONAL LENDING - **TRADE FINANCE**.
- **DEVELOPING COUNTRY DEBT** PROBLEMS.
- INTENSIFIED JAPANESE, EUROPEAN AND SOUTHEAST ASIAN **COMPETITION**.
- **ESTABLISHED MARKET** DISTRIBUTION PATTERNS.
- **LACK OF LONG-TERM COMMITMENT** ON THE PART OF THE BANK HOLDING COMPANY.
- BACKGROUND, TRAINING AND **"MENTALITY" OF THE BANKER**.

THE DRAMATIC DECLINE IN THE VALUE OF THE DOLLAR NOW MITIGATES THE FIRST PROBLEM. GNP LEVELS IN THE DEVELOPING WORLD HAVE INCREASED SINCE 1982. THE LACK OF TRADE FINANCE AND DEVELOPING COUNTRY DEBT PROBLEMS STILL PERSIST. THE COUNTRY DEBT DISASTER OF SEVERAL YEARS AGO PRECIPITATED THE DEMISE OR AT LEAST THE REORGANIZATION OF TRADE FINANCE ACTIVITIES AT MOST FINANCIAL INSTITUTIONS. BANKS CERTAINLY DO NOT EXHIBIT THE AGGRESSIVENESS IN INTERNATIONAL LENDING AS SHOWN 5-10 YEARS AGO. NOW WITH THE RENEWED MEXICAN DEBT CRISIS I FEAR A FURTHER DAMPENING IN THIS CRITICAL EXPORT SUPPORT AREA. I STRONGLY RECOMMEND THAT CONGRESS AND/OR THE ADMINISTRATION IMMEDIATELY **ESTABLISH A TASK FORCE** TO STUDY AND MAKE RECOMMENDATIONS ON EXPORT FINANCE IN ORDER TO HAVE **EFFECTIVE TRADE FINANCE** SUPPORT FOR OUR EXPORT POTENTIAL THROUGH THE END OF THE CENTURY. THE FOCUS MUST BE ON **COMMERCIAL** AS WELL AS **MILITARY SALES**.

ALTHOUGH THERE HAS BEEN AN INTENSIFYING OF FOREIGN COMPETITION WHICH HAS

CONTINUED TO BRING ABOUT THEIR SECURING OF CERTAIN MARKET DISTRIBUTION PATTERNS, THE PRESENT COMPETITIVE VALUE OF THE DOLLAR COUPLED WITH THE HIGH QUALITY STANDARDS OF AMERICAN PRODUCTS AND A FIRM **"YANKEE TRADER"** COMMITMENT - THE **COMPETITION CAN BE OVERCOME** AND DISTRIBUTION PATTERNS CHANGED.

FROM MY OWN EXPERIENCE AT BANKERS TRUST AS WELL AS OBSERVING OTHER MAJOR BANKS, I DO NOT BELIEVE BANKS HAVE THE NECESSARY FORTITUDE OR PATIENCE TO CONFRONT THE APPROPRIATE INVESTMENT LOSSES IN BUILDING AN ETC. THIS LACK OF LONG TERM COMMITMENT IN LIGHT OF ADVERSE ECONOMIC CONDITIONS, COMPETITION AND A TOTALLY "NEW BUSINESS" IS NOW EXEMPLIFIED BY SO MANY BANKS BACKING AWAY FROM COMMITMENTS THEY MADE OVER THE PAST TWO YEARS. MANY OF THESE INSTITUTIONS HAVE BACKED DOWN FROM THEIR ORIGINAL OBJECTIVES TO THE POINT THEY ARE ONLY DOING FINANCIAL TRANSACTIONS, WHICH **THEY DO NOT NEED AN ETC** TO PERFORM. OTHERS HAVE EITHER CLOSED THEIR DOORS OR ARE IN THE PROCESS OF UNWINDING.

ASIDE FROM THE LACK OF AT LEAST A MEDIUM-TERM COMMITMENT, BANKERS ARE NOT BUSINESSMEN. **BANKERS ARE CREDIT TRAINED**, THEREFORE BY BACKGROUND AND TRAINING THEY VIEW A TRADE RELATED OPPORTUNITY NOT FROM THE VIEWPOINT OF PERFORMANCE AND TRANSACTION RISKS BUT FROM A CREDIT PERSPECTIVE. THEY DO NOT HAVE THE TRAINING TO EVALUATE WHETHER EITHER PARTY TO A TRADE CAN PERFORM BUT INSTEAD INAPPROPRIATELY EVALUATE THEIR CREDIT WORTHINESS. A PERSON IN BUSINESS (INDUSTRIALIST) UNDERSTANDS THE NECESSARY INGREDIENTS NEEDED TO MAKE A SUCCESSFUL TRANSACTION. THE BUSINESSMAN UNDERSTANDS AND CAN APPROPRIATELY EVALUATE THE RISKS OF A TRANSACTION AND RELATIVELY QUICKLY MAKE A "GO/NO GO" DECISION.

BANK TRAINING AND PROCEDURES PRECLUDE OR AT LEAST MITIGATE THIS NORMAL BUSINESS PROCESS FROM EFFICIENTLY OCCURRING.

ETC IS A BUSINESS

BEAR IN MIND, I HAVE WORKED WITH BANKS FOR OVER TWENTY YEARS AND NEVER APPRECIATED THIS FLAW UNTIL I WORKED IN A BANK. I AM PROBABLY MORE DISAPPOINTED THEN MOST THAT BANKS HAVE BEEN UNABLE TO SUCCEED WITH THEIR ETC'S. I STILL FIRMLY BELIEVE BANKS **HAVE ALL THE INGREDIENTS FOR SUCCESS** - MARKET AND RESOURCES - IF ONLY THEY WOULD ALLOW BUSINESSMEN TO **OPERATE THESE BUSINESSES AS A BUSINESS.**

S2718, THE 1980 BILL, CONTAINED A SECTION ENTITLED "ADDITIONAL VIEWS OF SENATORS TOWER, CRANSTON AND GARN." THEY EXPRESSED THEIR CONCERNS ABOUT BANKS SIGNIFICANT DEPARTURE FROM THEIR TRADITIONAL BUSINESS. THEY NOT ONLY QUESTIONED THE SAFETY OF DEPOSITORS' FUNDS AND STOCKHOLDER INTERESTS BUT ALSO "THE ABILITY OF BANKING ORGANIZATION PERSONNEL TO MANAGE COMMERCIAL VENTURES...." I'M SORRY TO SAY THE SENATORS APPEAR TO HAVE HAD REALISTIC APPROPRIATE CONCERNS AS TO THE BANKERS' ABILITY TO MANAGE A COMMERCIAL ENTERPRISE. AS TO THE SAFETY QUESTIONS, BANKS ARE CONSERVATIVE ENOUGH TO FULLY MAINTAIN THAT TRUST.

ALL THE PROPOSED CHANGES (AMENDMENTS) UNDER S1934 TO THE PRESENT LEGISLATION ARE NEEDED AND I FULLY SUPPORT. IF THE BANKS ARE GOING OUT OF THE TRADING BUSINESS THEN I GUESS WE ARE DEALING IN AN EXERCISE IN FUTILITY AND WE SHOULD

PRODUCTIVELY BE FOCUSING OUR EFFORTS ON THE BUSINESS COMMUNITY'S ESTABLISHMENT AND EXPANSION OF ETC'S.

MASSIVE TRADE DEFICITS

IN 1982, WHEN THE ETC LEGISLATION WAS PASSED OUR TRADE DEFICIT WAS APPROXIMATELY $40 BILLION; IN 1986 FOR THE SECOND YEAR IN A ROW (DESPITE THE DECLINE IN OUR OIL IMPORT BILL) OUR TRADE DEFICIT WILL EXCEED $100 BILLION. IN THE FOUR YEARS SINCE 1982, THE NEED FOR THE ETC LEGISLATION EXISTS MORE THAN EVER BEFORE. WE MUST **EXPAND OUR EXPORT BASE** AND DERIVE ALL THE ATTENDANT **ECONOMIC BENEFITS**. EXPORT EXPANSION MUST BE A **NATIONAL PRIORITY**.

I STILL FIRMLY BELIEVE THAT EXPORT TRADING COMPANIES REPRESENT ONE OF THE MECHANISMS THAT WILL HELP **REVOLUTIONIZE AMERICAN TRADE**. THE ETC FORMATION PROCESS HAS BEGUN, THE "SOUL SEARCHING" AND RE-ANALYSIS IS CONTINUING AND EXPORTS HAVE BEEN STIMULATED. AS REPRESENTATIVE DON BONKER RECENTLY STATED, "NOW MORE THAN EVER, WE MUST DO EVERYTHING WE CAN TO NURTURE THESE VEHICLES FOR EXPANDING U.S. MARKETS."

ETC'S ARE CERTAINLY NO PANACEA AND ACTUALLY ONLY REPRESENT A PART OF OUR EXPORT SUPPORT TOOLS. TOGETHER WITH THE INCLUSION OF ALL APPROPRIATE EXPORT INCENTIVES - WE CAN SHOW THE WORLD THAT WHEN IT COMES TO TRADE **AMERICA MEANS BUSINESS**.

IMED
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STEPHEN SOHN

Mr. Sohn enjoys a worldwide reputation as an expert in International Trade and Finance. He is President of International Management and Export Development Corporation (IMED) focusing on multilateral trade promotion techniques including overseas investment, technology transfer, countertrade, offsets, trade finance, foreign military sales (FMS), and Washington Executive Branch and Congressional trade initiatives using proven innovative proactive methods.

Mr. Sohn is also a Vice President of International Data Bank (IDB) which is a company involved in developing a database of international trade information that is used by a worldwide network of associate trading companies and producers to facilitate trade transactions.

Previous to establishing IMED he formed and was President and Chief Operating Officer of Bankers Trust International Trading Company (BTITC) specializing in countertrade and offsets. Prior to joining BTITC he was Vice President of United Technologies Credit Corporation responsible for international financing, Washington trade representation and business association affairs. He joined United Technologies International in 1975 as Treasurer and Chief Financial Officer. He previously had more than ten years' broad experience in high technology companies covering Aerospace, Telecommunications and Medical Equipment in the areas of Foreign Investment, Public Accounting, Treasury, International and Corporate Finance.

Mr. Sohn's clients are in a variety of industries including Aerospace, Defense, Electronics, Engineering, Construction, Commercial Banking, European Regional Chamber of Commerce and Industry.

He received his MBA from Fordham University, is married with three children and resides in Fairfield, Connecticut.

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AFFILIATIONS

- Aerospace Industries Association of America
  - Chairman, International Council
  - Chairman, International Finance Committee
  - Member, Executive Committee
- American Defense Preparedness Association
- Consultant on Trade and Export Finance to the United States Trade Representative (White House)
- Chamber of Commerce of the United States
  - International Policy Committee
  - Export Policy Task Force - Chairman, Export Finance Committee
  - Past Chairman, Government Programs Committee
- National Association of Accountants
- Private Export Funding Corporation (PEFCO)
  - Advisory Board and Loan Committee

PUBLICATIONS

"Multi-Lateral Trade in a Non-Traditional World", The Treasurer, United Kingdom, October, 1984.
"BAHRAIN - The Singapore of the Middle East?", July 1979.

CONGRESSIONAL TESTIMONY

Senate Foreign Relations Committee
Senate Banking Committee
House Banking and Urban Affairs Committee
House Ways and Means Committee
House Foreign Affairs Committee

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM

R. DAVID LUFT

UNITED STATES DEPARTMENT OF COMMERCE
International Trade Administration
Washington, D.C. 20230

JUL 18 1986

Q-1: During the June 17 hearing Mr. Johnson of the Federal Reserve Board said "there is no evidence that ETCs affiliated with banks have been any less successful than trading companies that have no connection with banking organizations". If that is true how can you contend that it is the Federal Reserve Board's administration of Title II of the ETC Act that prevents U.S. export trading companies from being able to compete with foreign owned ETCs? After all the Fed has no jurisdiction over nonbank affiliated ETCs?

Please comment explaining your answer in some detail.

A. 1. During the June 17 hearing, Governor Manuel H. Johnson, Jr. of the Federal Reserve Board stated: "There is no evidence, however, that ETCs affiliated with banks have been any less successful than trading companies that have no connection with banking organizations. Many of these trading companies reported to the GAO that business has been disappointing, citing economic factors, particularly the high value of the dollar, as the reason." With the addition of the second sentence of Mr. Johnson's statement (which was not cited in Senator Proxmire's question), I deduce that Mr. Johnson is comparing Department of Commerce-certified ETCs with bank-affiliated ETCs formed under Title II of the ETC Act in the context of the GAO report (which uses data up to October 1, 1985). Given this background, Mr. Johnson's statement is open to readily understandable misinterpretation. A better formulation would have been, "We are unaware of any empirical study which demonstrates at a high level of confidence that bank-affiliated ETCs are either more or less successful than nonbank ETCS in terms of export sales volume, profits, return on equity, etc."

Senator Proxmire's question reads, "If that is true how can you contend that it is the Federal Reserve Board's administration of Title II of the ETC Act that prevents U.S. export trading companies from being able to compete with foreign owned ETCs? After all the Fed has no jurisdiction over nonbank-affiliated ETC?" Based on the discussion in paragraph one, no one would be able to ascertain whether or not the first sentence of Mr. Johnson's statement is "true"; however, one can conclude that the sentence in question is empirically not valid. In any case, the "success" (however defined) of U.S. bank-affiliated ETCs *vis a vis* U.S. ETCs not affiliated with U.S. banks is irrelevant to my contention that it is the Federal Reserve Board's administration of Title II of the ETC Act which prevents U.S. bank-affiliated ETCs from competing effectively against foreign bank-affiliated ETCs. (I would like to clarify that I did not contend that the Federal Reserve Board's administration of Title II prevents U.S. ETCs not affiliated with banks from being able to compete with foreign-owned ETCs.)

My contention is based on a comparison of Japanese bank-affiliated trading companies, in particular the Sogo Shosha, with U.S. bank-affiliated trading companies. From an analysis of the information contained in the major accounting firm's study of the Sogo Shosha which I mentioned in my testimony (John Gunther-Mohr and Richard V. L. Cooper, *Foreign Trading Companies: Lessons for U.S. Banks*, Coopers & Lybrand, 1984), I am forced to conclude that if the Export Trading Company Act of 1982 were a Japanese law and the present Federal Reserve implementing regulations were in force, the nine largest -- and most successful -- Japanese trading companies (which are bank affiliated via the Zaibatsu) would be unable to comply. For 1983, which is the latest financial data in the study, the Sogo Shosha did not meet the Federal Reserve's 50 percent revenue test both because they have substantial sales in Japan and because a substantial share of revenues is derived from sales between third countries which would be counted on the import side under present Federal Reserve regulations. All of the Sogo Shosha exceed the Federal Reserve's inventory limitation of $2 million without firm orders for resale. Finally, the Sogo Shosha also do not comply with Section 23A of the Federal Reserve Act. It is a matter of fact, then, that the Japanese trading companies both do not comply with the Federal Reserve's implementing regulations of Title II of the ETC Act and that no such regulations restricting the activities of Japanese trading companies exist in Japan. From this analysis the conclusion that U.S. bank-affiliated export trading companies are at a serious competitive disadvantage with respect to their generally acknowledged most successful foreign competitors as a consequence of the Federal Reserve's interpretation of Title II of the ETC Act of 1982 appears inescapable.

I would like to add that bank-affiliated ETCs are also at a competitive disadvantage with respect to domestic ETCs not affiliated with U.S. banks. A bank-affiliated ETC is not permitted to engage in any activity that is not related to international trade. In contrast, there is no statutory prohibition against a nonbank ETC participating in a purely domestic transaction. Under the Federal Reserve's regulations, a bank ETC is precluded from investing in any service company (e.g., insurance, construction management, retailing) that provides its own services to customers overseas. No such prohibition applies to nonbank ETCs. Under current Federal Reserve administrative practices, bank-affiliated ETCs are effectively limited to a leveraging ratio of 10:1 or less. Higher leveraging ratios are approved on an exception basis (currently only one exception at 17:1 exists) and are inversely proportional to the Federal Reserve's judgment of the riskiness of the line of business. Nonbank ETCs are limited only by market factors, i.e., the soundness of their operations and their ability to negotiate higher ratios. Although many loans to nonbank ETCs require adequate collateral as a condition imposed by the lender, bank-affiliated ETCs are required to post such collateral in all instances by virtue of the statutory application of Section 23A of the Federal Reserve Act. The requirement that bank ETCs derive more than 50 percent of their revenues from exporting can force them to forego a potentially profitable transaction in order to stay within the 50 percent requirement; nonbank ETCs need have no concern about the percentage of their revenues derived from exporting.

Through its administrative practices the Federal Reserve limits the amount of inventory a bank-affiliated ETC may hold for its own account to $2 million. Nonbank ETCs are not subject to a regulatory limit and can, therefore, carry whatever inventory level is consonant with international market conditions. Unlike bank ETCs which are prohibited by statute from taking positions in commodities or commodity contracts, in securities, or in foreign exchange except as may be incidental to their normal business operations, nonbank ETCs are not subject to such a prohibition. Another statutory prohibition to which nonbank ETCs are not subject is the prohibition against bank-affiliated ETCs engaging in agricultural production activities or in manufacturing except for such incidental product modifications as repackaging, reassembling or extracting byproducts to the extent necessary to enable the U.S. goods to conform to foreign requirements for sale.

While I do not wish to imply that I favor the full elimination of the separation of banking and commerce, it is my opinion, based on the research conducted for the purpose of answering Senator Proxmire's questions as well as my experience as an international commercial banker dealing with both European and Japanese trading companies, that the Federal Reserve's implementing regulations for Title II of the ETC Act are at variance with Section 102 of Title I of the Act. The Federal Reserve's present regulatory interpretation of Title II virtually ensures the abiding truth of Title I, Section 102(a)(8) of the Act, i.e., "the development of export trading companies in the United States has been hampered...by Government regulations." Enactment of S. 1934 would return to bank-affiliated ETCs the operational flexibility required to profitably engage in international trade on a scale envisioned in the ETC Act. Continuation of the status quo carries with it the high probability that bank holding company interest in the formation of bank-affiliated ETCs will reach a state of moribundity in the not-too-distant future and that the activities of existing bank-affiliated ETCs will be increasingly relegated to the crepuscular.

I am also including with this letter the results of a telephone inquiry conducted April 30 to May 2 of this year by a member of my staff which produced a list of bank-affiliated ETCs that differs somewhat from that provided by Mr. Johnson. For example, a number of bank ETCs that are shown as operational in the Federal Reserve's list are shown as closed in the list I am including. I would also like to comment on Governor Johnson's written submission to your subcommittee. On page 12, Governor Johnson states, "S. 1934 would modify the definition of an ETC to include companies that principally export goods or services produced by themselves or any of their affiliates. This revision would permit a bank to invest in any company that provides its own services to foreign customers regardless of whether the services relate to trade." I would like to point out that when a domestic "company provides...its own services to foreign customers" it is considered an export of U.S. services and is thus related to trade -- trade in services. On page 14 Governor Johnson states, "The practical effect of S. 1934 would be to change the Congressionally intended emphasis in the BESA from promoting U.S. exports and employment to providing a vehicle by which commercial banking organizations, through the medium of an ETC, could acquire organizations serving overseas customers without benefit to the United States trade or balance of payments position." I should like to point out that the Federal Reserve already permits bank-affiliated ETCs to "acquire organizations serving overseas customers without benefit to the United States trade or balance of payments" as indicated in Governor Johnson's example, cited on the previous page, of an ETC that has acquired, "a company in England that engages in customs bonding services and in certain types of inventory control services related to cross-border trade." The ETC's investment in the company in England was a debit for the U.S. balance of payments and a credit for the balance of payments of the United Kingdom. The sales of the company in England to non-U.K. customers will benefit the British balance of payments on trade in services. However, there will be a benefit to the United States balance of payments if and when the company in England remits profits to the U.S. ETC which owns it.

On page 15 Governor Johnson deals with the method of revenue calculation proposed in S. 1934. I would like to point out that a U.S.-domiciled ETC which is "substantially engaged in third party trade or countertrade" would be engaging in the export of a U.S. service and the revenues derived from such a services export would be shown as a credit in the U.S. balance of payments when remitted. It is therefore a non sequitur to argue as does Governor Johnson that the revenue calculation proposal contained in S. 1934 would result in "... a substantial alteration of Congressional intent as to the purposes of ETCs to promote the export of U.S. goods and services and would be contrary to the original premise for allowing bank holding companies to engage in this activity: that the increased risks undertaken by a bank holding company through an ETC would be counter-balanced by an increase in U.S. exports."

Moreover, there is a fundamental discord between the Federal Reserve's method of revenue calculation, which counts revenues derived from third party trade or countertrade involving two foreign countries facilitated by a U.S. domiciled bank-affiliated ETC as an import, and the method followed in balance of payments accounting which counts such revenues as U.S. services exports when remitted. The U.S. has recently gone through a period during which the high value of the U.S. dollar made many U.S. products price uncompetitive with their foreign equivalents, which in turn led to a substitution of foreign-produced goods for those which had been exported from the U.S. when the value of the U.S. dollar was lower. If the S. 1934 method rather than the Federal Reserve's present method of revenue calculation had been in place during the recent period of the high value of the U.S. dollar, there would have been at minumun the potential for U.S. bank-affiliated ETCs to capture part of the revenues derived from third party trade for the benefit of the U.S. balance of payments and for the benefit of U.S. service sector employment.

Some indication of potential benefits for the U.S. if the S. 1934 method of revenue calculation were adopted can be derived from the data given in the Coopers and Lybrand study cited earlier. In FY 1983 the nine Sogo Shosha had $54.4 billion of sales (15 percent of total sales) derived from offshore (i.e., third-party) trade. Since the profit margins of the nine Sogo Shosha during this period were between one-half and two percent, the profit on third-party trade for the group was between $272 million and $1.09 billion which represents a not inconsequential benefit for the Japanese balance of payments to the extent remitted.

I thank you and Senator Proxmire for your invitation to comment in detail. I am at the Subcommittee's service should further clarification be required.

Sincerely,

R. David Luft

R. David Luft
Deputy Assistant Secretary
for Services

Enclosure

BANK HOLDING COMPANY	EXPORT TRADING COMPANY
Shawmut Corporation Boston, MA	Shawmut Export Corporation James G. Dadmun, Executive V. P. Techexport, Inc. 244 2nd Avenue Waltham, MA 02154 617-890-6507
Fleet Financial Group, Inc. Providence, RI	Fleet Trading Company Donald Crane, Assistant V.P. 111 Westminster Street Providence, RI 02920 401-278-5739
Hong Kong and Shanghai Banking Corp. Hong Kong	Equator Trading Company Michael P.H. Stephenson, President 111 Charter Oak Avenue Hartford, CT 06106 203-249-7776
Bankers Trust New York Corp. New York City	Bankers Trust International Trading Corp. Jeffery Glibert, President 280 Park Avenue New York, NY 10017 212-850-1758
Citicorp New York City	Citicorp International Trading Co., Inc. Ms. Heidemarie Stanton, Assistant Vice President 399 Park Avenue 10th Floor, Zone 11 New York, NY 10043 212-559-8818
Chase Manhattan Corporation New York City	Chase Trade, Inc. Gary Marcus, Vice President One World Trade Center 78th Floor New York, NY 10048 212-432-8075
Marine Midland Banks, Inc. Buffalo, NY	Marine Midland Trade, Inc. Joseph Ruggerello, President 140 Broadway, 5th Floor New York, NY 10015 212-440-1590

BANK HOLDING COMPANY	EXPORT TRADING COMPANY
Manufacturers Hanover Corp. New York City	Manufacturers Hanover World Trade Corp. Malcolm P. Davies, President 140 East 45th Street New York, NY 10017 212-808-0810
First Fidelity Bancorporation Newark, NJ	First Fidelity Tradexport Corp. A. Philip Ferzan, General Manager 550 Broad Street Newark, NJ 07192 201-565-5780
Ramapo Financial Corp. Wayne, NJ Ultra Bancorporation Bridgewater, NJ New Jersey National Corp. Trenton, NJ	Bancorp's International Trading Corp. John L. Willer, President Two Worlds Fair Drive Somerset, NJ 08873 201-560-3650
Maryland National Corp. Baltimore, MD	MN Trade Corporation James A. Kayler, Managing Director 120 East Redwood Street Baltimore, MD 21202 301-244-5160
First Union Corporation Charlotte, NC	First Union Export Trading Company David G. Morrow, Vice President First Union Plaza - Corp. 16 Charlotte, NC 28288 704-374-3112
CoreStates Financial Lancaster, PA	CoreStates Export Trading Company Harry G. Hayman III, President Broad and Chestnut Streets Philadelphia, PA 19101 215-629-3092
Captial Bancorp Miami, FL	Capital Trade Services, Inc. Lewis A. Portal, Executive V.P. 5901 NW 36th Street Miami, FL 33166 305-871-2268

BANK HOLDING COMPANY	EXPORT TRADING COMPANY
Commerce Union Corporation Nashville, TN	Commerce Trading Corp. Phil Hamilton, President One Commerce Place Nashville, TN 37219 615-749-3027
First Chicago Corporation Chicago, IL Note: First Chicago Trading Company is a joint venture with Sears World Trade.	First Chicago Trading Company Abelardo Curdumi, Managing Director One First National Plaza, Ste 0042 Chicago, IL 60670 312-732-5047
Marine Corporation Milwaukee, WI Note: Marine Financial Services, Inc. is a FSC management company, not a bank ETC.	Marine Financial Services, Inc. Jack Schall, Assistant V. P. P.O. Box 975 Milwaukee, WI 53201 414-765-3086
First National Bancshares, Inc. Houma, LA	First Export Corporation Edward Brady, President 600 East Main Street, Ste 301 Houma, LA 70361 504-868-1660
InterFirst Corporation Dallas, TX	InterFirst World Trade Corporation Ronald Steinhart, President P.O. Box 83000 Dallas, Texas 75283-1040 214-977-3302
United Bancorp of Arizona Phoenix, AZ	United Bank Export Trading Company James Leinenkugel, President P.O. Box 2908 Phoenix, AZ 85062 602-248-2438
Valley National Corporation Phoenix, AZ	Valley International Trading Company Constantino Novoa, President 3250 Camelback, Suite 200 Phoenix, AZ 85018 602-957-0057

BANK HOLDING COMPANY	EXPORT TRADING COMPANY
Union Bancorp, Inc. Los Angeles, CA	StanChart Export Services Co., Inc. Michael Granat, President 400 Oceangate, Suite 400 Long Beach, CA 90802 213-236-5416
Security Pacific Corporation San Francisco, CA	Security Pacific Export Trading Company Joseph Seghali, President 350 South Figueroa Street, Ste 210 Los Angeles, CA 90071 213-613-7006
First Interstate Bancorp Los Angeles, CA	First Interstate Trading Company Kenneth Rosenburgh, President 707 Wilshire Blvd., 28th Floor Los Angeles, CA 90017 213-614-5320
North Valley Bancorp Redding, CA	Casia-Pacific Company Larry Sawyer, Senior V. P. P.O. Box 4638 Redding, CA 96099 916-221-8400
BankAmerica Corporation San Francisco, CA	BankAmerica World Trade Corp. Daniel Cecchin, President 555 California 42nd Floor - Dept. 3921 San Francisco, CA 94104 415-622-3456
U.S. Bancorp Portland, OR	U.S. World Trade Corp. Lothar Paesler, Executive V. P. 111 SW 5th Avenue, Suite 19 Portland, OR 97204 503-220-8100
Rainier Bancorporation Seattle, WA	Rainier International Trading Company John Lewis, Manager P.O. Box 3966 (T23-4) Seattle, WA 98124 206-621-3457
Alaska Mutual Bancorporation Anchorage, AK	Mutual International Corp. Donald G. Wold, President 601 West 5th Avenue, Ste 100 Anchorage, AK 99501 901-274-5535

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BANK ETCs NO LONGER IN BUSINESS

BANK HOLDING COMPANY	BANK ETC	CURRENT STATUS
Walter E. Heller International Corporation Chicago, IL	Heller Trading Company	Closed
First Kentucky National Corporation Louisville, KY	First Kentucky National Trading Company	Closed
Crocker National Corporation San Francisco, CA	Crocker Pacific Trade Corporation	Closed
State Street Boston Corp. Boston, MA	State Street Trade Development Corp., Inc.	Sold to Cambridge International
International Bancshares Corp. Laredo, TX	IBC Trading Company	Closed Never Opened
United Midwest Bancshares Inc. Cincinnati, OH	United Midwest Int'l Corporation	Closed
Society Corporation Cleveland, OH	Export Partnership for Int'l Trade, Inc.	Not Operating
Frontier Bancorp Vista, CA	Interbank Trading Co. San Diego, CA	Closed
Florida Park Banks, Inc. St Petersburgh, FL	Park Services International Inc.	Closed
Ramapo Financial Corp Wayne, NJ Ultra Bancorporation Bridgewater, NJ New Jersey National Corp. Trenton, NJ	Florida Interbank Trading Co., Inc.	Closed
First Wisconsin Corp. Milwaukee, WI	InterContinental Trading Co., Inc.	Closed
Manufacturers Hanover Corp. New York, NY	C.I.T. International Sales Corp.	Merged & desolved

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM
ALLAN I.MENDELOWITZ
SENIOR ASSOCIATE DIRECTOR
NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION

Q-1. You contended in your June 17 testimony that the reason U.S. bank affiliated ETCs have not prospered is at least in part due to the way the Federal Reserve administers Title II of the ETC Act. You contended further that changes to Title II made by S.430 "will go a long way" toward curing the problems of bank affiliated ETCs.

How do you account for the poor performance of nonbank affiliated ETCs during the period since enactment of the ETC Act? Are not the reasons they have not done well the same reasons, for the most part, why bank-affiliated ETCs have not done well?

A. In our testimony we stated that Bank ETC's believe that certain provisions of the Act and certain Federal Reserve Board regulations and policies have affected or will affect their export performance, potential to compete with foreign-owned trading companies, and ability to survive.

Of particular concern are the Board provisions that bank ETC's (1) must derive more than 50 percent of their revenue from exporting, with third-country trade and countertrade counted as non-export revenue, (2) cannot invest in firms that themselves export services, (3) must observe the same collateral requirements as non-bank affiliates when borrowing from parent banks, (4) must have a leveraging, or asset-to-capital, ratio not greater than 10 to 1, thereby limiting the amount that can be borrowed and (5) must have proposals to take title to goods in excess of $2 million (except against firm orders) approved by the Federal Reserve Board instead of the Federal Reserve Banks. We also stated that S.1934 would make changes to address these and other matters.

However, as we observed in our testimony, the poor performance of all ETCs are attributable to the same fundamental economic reasons. U.S. export performance is determined by many variables, including the level and growth of gross national product in foreign countries; the value of the dollar, the availability of international lending and the current developing country debt problems; U.S. technological leadership, foreign tastes, preferences, and barriers to U.S. products; U.S. business attitudes; and impediments to U.S. exports created by U.S. laws and regulations. The most important determinants are fundamental economic factors, such as foreign economic growth and relative exchange rates. The negative influence of these fundamental factors could not be offset by whatever impediments to exports were removed by the Export Trading Company Act, so that the Act itself cannot guarantee success of ETCs. But, S.1934 would remove specific impediments to the success of bank ETCs that are attributable to Federal Reserve Board regulations, and enhance their ability to export.

Q-2 Has your agency conducted any studies on the lending practices of U.S. banks vis a vis ETCs? Is there any reason to believe that bank-affiliated ETCs would be unable to obtain financing from unaffiliated lenders for reasons other than creditworthiness?

A. GAO has not conducted any studies on the lending practices of U.S. banks vis a vis ETCs. We are not aware of any reasons why bank-affiliated ETCs would be unable to obtain financing from unaffiliated lenders for reasons other than credit worthiness. As a practical matter we would expect bank ETCs to obtain loans from their affiliated banks.

Q-3 Why do you think nonbank-owned ETCs can't get financing? If the risk is so great in lending to nonaffiliated ETCs, why should a bank be less stringent in lending to an affiliated ETC?

A. We did not say that nonbank-owned ETCs can't get financing. Whether or not nonbank-owned ETCs can get financing is dependent on the respective credit ratings of these firms. We are not aware of any reasons why a bank should apply different levels of stringency in lending to affiliated or unaffiliated ETCs. The primary basis for bank loans should be credit worthiness of the firm seeking the loan. Officials of bank ETCs are in effect asserting that the Federal Reserve Board regulations, as applied to affiliated bank ETCs, are unnecessarily stringent and unduly raise the costs of doing business.

Q-4 If we adopt this legislation, how do we ensure that all ETCs have equal access to credit if banks favor their affiliates?

A. Considering the very small capital requirements of ETCs relative to the resources of the banking sector, we do not believe that the capital needs of ETCs will result in any crowding out or capital shortages for any category of borrower.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM MALCOLM P. DAVIES

Q. 1 During testimony before the International Finance Subcommittee on S. 1934, the Export Trading Company Amendments Act of 1985, some participants took issue with the provision of S. 1934 that would permit an ETC to export [goods and] services produced by itself or its affiliates or to provide "export trade services to facilitate the export of goods or services produced in the U.S. by unaffiliated persons." It was argued that this provision would open the door to U.S. banks getting involved in all manner of non-bank services inside and outside the United States including things like manufacturing. Could you comment on what you see as the impact of this provision of S. 1934 and the extent to which it represents a significant expansion of bank powers?

Response

We believe that the provision of S. 1934 permitting ETCs owned by bank holding companies to export their own services or those of affiliates should have a highly favorable impact on ETC operations. Income from such activities would make it easier for ETCs to meet the "principally" test and would be a positive factor in the U.S.'s current account.

We do not believe this provision would involve any significant expansion of powers, for the following reasons:

> (i) This provision would result in no expansion of bank powers. Banks affiliated with ETCs through common bank holding company ownership derive their powers from federal or state banking laws. This provision would have no impact on such banking laws. What this provision would do, would be to permit an ETC to export services provided by a bank affiliate under existing state or federal law.
>
> (ii) The ETC Act specifically provides that an ETC must be "exclusively engaged" in activities related to international trade. This specific limitation was included in the ETC Act to prevent ETCs from engaging in domestic business activities. This limitation would continue to apply even if ETCs were permitted to export their own goods and services. Thus, an ETC could not use this provision to engage indirectly in domestic activities.

(iii) The ETC Act specifically prohibits an ETC from engaging in any agricultural production or manufacturing activities (except for incidental product modification), wherever located.

(iv) The ETC Act specifically prohibits an ETC from engaging in any securities activities in the United States not permissible for a bank holding company, and also specifically prohibits an ETC from engaging in any domestic insurance activities (with the exception of certain insurance covering the U.S. portion of international shipments).

In sum, we believe the Congress has already made it crystal clear in the ETC Act, that bank holding companies cannot use ETCs to expand into domestic activities, especially such politically-sensitive activities as securities, insurance or manufacturing. Those provisions would continue to apply if S. 1934 were enacted.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM MALCOLM P. DAVIES

Q.1 On page 5 of your testimony you list some reasons why bank-affiliated ETCs have not fulfilled expectations of some that they would be a major force in export promotion. One reason you cite is "the absence of commercial trading experience in banking organizations." This sounds much like Mr. Sohn, formerly of Bankers Trust, who contends that bankers "do not have the training to evaluate whether either party to a trade can perform, but instead inappropriately evaluate their credit worthiness."

In view of the problem banks have had in trying to cross into the trade culture at a particularly difficult period for exporters, do you think there is any merit in the Fed's contention that Congress ought not make changes in existing law until it has had a longer testing period during a more favorable climate for exporters?

Response

We must respectfully disagree with the Federal Reserve on this issue. To encourage existing ETCs and other bank holding companies (BHCs) to expand their ETC activities, a much more liberal regulatory environment is needed. For example, the existing revenue test distorts the response to business opportunities. Does a U.S. ETC turn away a transaction which involves the ETC supplying Turkish goods to the P.R. of China because its revenue test will be that much more difficult to meet? What happens later when a U.S. customer wants to sell to that same Turkish customer? Will the Turkish customer, in fact, still be a customer, if the U.S. ETC cannot assist in his third country export? It would be preferable if such third country business were to be neutral in meeting the test.

The Federal Reserve's argument that the intent of the law was not to turn U.S. bankers into traders but rather export traders is to miss the point envisaged by the Act; namely, that a company has to establish professional credibility among customers who can deal with international competitors that are not circumscribed by a principally engaged test. To the extent that BHC ETCs have had problems, such problems may have derived from their singular export orientation at a time when U.S. goods were priced out of world markets.

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The cultural problem is not one of being unable to make the correct type of evaluation of the customer, as indicated by Mr. Sohn, but rather one of educating banking personnel to see trading (as well as banking) opportunities in the information that crosses their desks daily.

Rather than wait for a more favorable climate for exporters to see how the BHC ETCs do, we should be encouraging the development of trading expertise. With trading confidence established, opportunities for export will not be ignored.

Q. 2 In a follow up to my prior question I note that on page 9 of your testimony you state that BAFT strongly supports the provision in the Heinz bill that would provide that "principally means an excess of export-related revenues over import revenues, thereby excluding third country transaction revenues from the test entirely."

Isn't it true that no bank affiliated ETC has had any problem meeting the Fed's definition of principally and the problem is solely an anticipatory one?

Response

We know of one BHC ETC that closed because it could not find the required export/import balance in its activities. We do not know whether it was examined by the Federal Reserve prior to its decision to close. While the problem is mainly anticipatory, it is presenting more problems as more and more ETCs face the end of their first two-year computation period.

Q. 3 Mr. Davies, at our June 17 hearing you said that small nonbank export trading companies are for the most part undercapitalized and they have been relatively unsuccessful for that reason. If there are profits to be made in running ETCs, why are these companies undercapitalized? Why does an ETC have to be affiliated with a bank in order to raise adequate capital? Does it have anything to do with the fact that export trading is a rather risky business?

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Response

U.S. trading companies (and export management companies) have tended to be "niche" operations exploiting an individual's specialized knowledge of a particular market. Such personal skills cannot be delegated to any extent. This limits growth potential.

Export trading is "more risky" than domestic business but the degree of risk varies very widely and many markets would not be significantly riskier. There are also various risk mitigating techniques available such as confirmed letters of credit and credit insurance which the experienced exporter uses all the time.

The reason that the U.S. has not been fertile ground for nonbank ETCs in the past is that the U.S. has enjoyed a big enough domestic market for the great majority of businesses to thrive without bothering with international business. The trade deficit now demands that a new tier of companies look to exporting and they need help to find markets. While the process of internal education goes on, BHC ETCs also need help in finding markets. The export "market makers" for BHC ETCs and their customers are not going to be IBM, GE and Boeing but the "niche" exploiters who can generate more deals or bigger deals in conjunction with a BHC ETC as the buyer and seller (and the financer) of goods in question. In many cases it is unlikely that a bank would consider the export "market maker" an appropriate credit risk if he were to seek to borrow funds to make the deals himself. Thus, we see an increasing partnership between nonbank ETCs and BHC ETCs, whereby the former find the export markets and customers, and the latter work with the former to do the actual deal, i.e., trading and financing.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM MANUEL H. JOHNSON, Jr.

Question 1. In your testimony before the International Finance Subcommittee on S. 1934, the Export Trading Company Amendments Act of 1985, you responded to a question on the issue of ETC leverage with the opinion that the failure of an ETC capitalized with 5% of the capital of its parent bank holding company and leveraged at 25:1 would cause the failure of the parent company. This seems an extremely improbable outcome, and one at variance with the example of a troubled ETC cited in your testimony which apparently did not represent a significant threat to its parent institution. Could you please elaborate on your answer and discuss the likelihood that poor management at an ETC could wipe out the capital of its parent bank?

Answer. The Bank Export Services Act provides that a bank holding company may not invest more than 5 percent of its consolidated capital and surplus in an export trading company ("ETC"). This investment limit alone is not enough to protect a bank holding company from harm resulting from the failure of its subsidiary ETC if that ETC is highly leveraged. To illustrate this point, Senator Proxmire asked whether a bank holding company could expose up to 125 percent of its capital by investing 5 percent in an ETC which is leveraged at 25:1 and could fail if the ETC failed. I agreed that such a result could occur. For example, assume that a bank holding company has $100 million in capital. It invests $5 million in an ETC and borrows $125 million to support its trading activities. If the ETC encounters difficulties and is unable to meet its obligations, the bank holding company is faced with two choices: it can walk away from the ETC or it can assume the ETC's liabilities. Either alternative would severely harm the bank holding company.

If it lets the ETC fail, the bank holding company will suffer damage to its reputation and likely a dramatic loss of confidence by the market in the bank holding company's ability to meet its other liabilities. Our experience indicates that bank holding companies therefore are unlikely to walk away from a troubled subsidiary. Alternatively, if the bank holding company assumes the ETC's liabilities, the bank holding company faces losses that exceed its own capital.

Admittedly, this is an extreme example, but it is entirely possible, especially if the ETC were engaged in activities of an especially risky nature, such as taking title to goods. Even in a less extreme case, where the capital of a bank holding company is sufficient to absorb any losses, the condition of the bank holding company will be weakened, reducing earnings and impairing its banks' ability to serve the credit needs of the public. A prudential measure to avoid such occurrences is to require that an ETC have adequate capital to support its operations and cope with the risks associated with its activities. As I stated in my testimony, the Congress itself, in enacting the International Lending Supervision Act of 1983 emphasized the necessity for the maintenance of adequate capital levels by banking organizations. Thus, the Board cannot support the presumption of S. 1934 that a leveraging ratio of 25:1 would, in all cases, be prudent.

In discussing the Board's position regarding the application of section 23A to transactions with ETCs, I mentioned a case where a bank lent to its affiliated ETC in violation of section 23A. This example is consistent with and supports our discussion of the need for ETCs to maintain adequate capital. In that particular case, the bank holding company invested a relatively modest amount in an ETC. However, the ETC then borrowed more than ten times this amount from its affiliated bank, none of which it was able to repay. Thus, the total losses to the bank holding company amounted to its entire initial investment plus ten times this amount in loan losses. Because the size of the investment was small, the bank holding company was able to absorb the losses. Had the ETC been more highly leveraged, the losses to the holding company would have been correspondingly greater and could have represented a more serious problem for the banking organization. In this instance, the losses to the banking organization resulted from its direct involvement in extending credit to the ETC (in violation of section 23A); but even had the loans been extended to the ETC by an unaffiliated bank, the parent holding company would in all likelihood have absorbed the losses. Accordingly, this example, while discussed in another context, reinforces our position that the leveraging ratio of an ETC can be assessed from a safety and soundness perspective only in the context of other factors, including the relative size of the bank holding company's initial investment and the riskiness of the proposed activities.

As mentioned in my testimony, what the appropriate ratio is depends crucially on the types of activities the ETC engages in. The more those activities are like those performed by a bank, the closer the ratio could be to that permitted banks. The more the activities are unlike those of a bank, (for example, if the ETC were dealing in goods) the more appropriate it would be for the ratio to approximate those of independent ETCs. (That ratio, as mentioned in the testimony, is in the neighborhood of 3:1.)

It would seem to be singularly inappropriate, at a time when Congress and U.S. bank supervisors are in agreement that the capital positions of banking organizations should be strengthened, to allow bank affiliated ETCs to operate with lower capital ratios than their affiliated banks. That would be the effect of S. 1934 and that is what the Board objects to.

Question 2. The leveraging of Japanese and other countries' ETCs was discussed at the hearing as instructive for U.S. regulatory practice. Leveraging of Japanese ETCs was cited as being routinely greater than 30:1. Could you comment on the capital structure of Japan's ETCs, discuss the appropriateness of the Japanese model for U.S. bank ETCs, and provide the Subcommittee any analysis the Federal Reserve has done on this issue to support its position on ETC leverage?

Answer. Japanese trading companies, which operate with very low capital ratios, are not an appropriate model for U.S. bank-affiliated ETCs. The Japanese government recognizes the risks of banks' affiliation with trading companies. Japanese banks are limited to a 7-1/2 percent equity investment in a trading company and the law requires a divestiture to no more than 5 percent by 1987. In contrast, U.S. bank holding companies may own up to 100 percent of the equity of an ETC, so long as their investment is less than 5 percent of their capital. It is thus meaningless to compare the risks to a Japanese bank with a small percentage interest in a highly leveraged ETC with the risks to a U.S. bank holding company owning 100 percent of a less highly leveraged ETC.